

# Authorised Short Term Money Market Dealers

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## 1. Introduction

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Authorised short term money market dealers are securities dealers which have a special contractual relationship with the Reserve Bank. They play a pivotal role in the money market as they are the entities through which the Bank primarily conducts its open market operations. They provide facilities for the investment of overnight and short term funds and are obliged to act as market makers in short term Commonwealth Government securities. Their operations also extend into other markets.

In recognition of their key role and to assist their operations the Bank provides dealers with some special facilities. These include liquidity support and clearing accounts at the Bank which give same-day value to dealers' transactions. In return, in addition to their market-making obligations, dealers are required to observe guidelines set by the Bank for capital adequacy, ownership and asset composition.

## 2. History

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The origins of the dealers date back to the 1950s. At that time the Australian financial system was relatively unsophisticated. Facilities for investing funds at interest for short periods were limited. The main outlets were to deposit funds with banks for fixed periods, with a minimum maturity of three months, or to purchase short-dated private or Commonwealth Government securities. To cater for this demand, a number of stock and share brokers began to offer an interest-bearing short term investment secured by "buy-back" arrangements on Commonwealth Government securities<sup>1</sup>. These facilities proved popular.

The Bank took a close interest in these activities, particularly since they were based on Commonwealth stock. In the late 1950s, it decided to formalise and nurture the embryonic market by accrediting certain dealers to conduct these operations under its guidance, in return for liquidity support and

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1. In essence, investors purchased securities from a broker who agreed to buy them back for a specified price at an agreed date. In other words, the brokers financed their portfolios of Commonwealth Government securities with short term loans.

other facilities. Thus were born the authorised dealers or official short term money market as it became known. Seven dealers were accredited in 1959, and a further two in 1960.

The number of authorised dealers remained unchanged until 1989. In recent years the Bank has withdrawn accreditation from one company, two new dealer companies have been authorised, two companies have merged, and one has withdrawn from the market. The eight dealers currently accredited are listed in Appendix A.

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### 3. Functions

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The authorised dealers have three key functions. They provide a facility for the investment of short term funds with minimal risk, they make a market in short term Commonwealth paper; and they are the prime counterparties for the Reserve Bank in its open market operations.

#### (a) Repository facility for short term funds

The core activity of authorised dealers is the acceptance of short term wholesale funds and the investment of these funds in short term securities. On the surface, such activities might seem unremarkable. The clue to the special role of the official dealers lies in the composition of their liabilities; they are the only entities which can provide the commercial banks with an alternative to the Reserve Bank as a repository for banks' cash reserves or exchange settlement funds.

Exchange settlement funds are used by the banks to settle obligations between themselves and with the Reserve Bank. The unique characteristic of these funds is that they give "same-day" good value, i.e. they are as good as cash. Transfer of value is effected instantaneously through debits/credits to the relevant accounts. Exchange settlement accounts must always be in credit but do not accrue interest, so banks aim to minimise balances in them.

To enhance earnings banks keep a substantial amount of their liquid funds at interest with the authorised dealers in the form of secured loans. Most of these funds are "at call" and can be withdrawn on any day if needed.

Dealers also accept loans from personal clients and non-bank institutions such as life offices, superannuation funds and industrial companies. Loans from these clients are made by bank cheque and are referred to as "next-day funds". While the authorised dealers get immediate credit for the cheques deposited, the Bank does not obtain good value for these cheques until inter-bank settlements for cheque exchanges are made on the next business day. It does, however, receive interest overnight from the owing banks. Personal clients represent a very small part of the non-bank funds lent to dealers.

All loans accepted by authorised dealers are fully secured by Commonwealth Government securities or defined private sector securities. Evidence of ownership of securities by dealers is delivered to clients or lodged with independent third parties.

#### (b) Market-makers

The authorised dealers make a market in short term Commonwealth Government securities and in repurchase agreements based on Commonwealth Government securities. To this end, they trade actively and consistently in these securities. Some data on turnover are provided later in this article.

They are also permitted to hold and trade a restricted range of bank and public authority securities, as well as longer-term Commonwealth stock.

#### (c) Counterparties for Reserve Bank open market operations

The Reserve Bank conducts the bulk of its domestic open market operations with the authorised dealers. It deals with them in the same securities in which they make markets, i.e. short term Commonwealth Government securities (less than 1 year) and repurchase agreements based on Commonwealth

Government securities. The dealers' capacity to deal in both the exchange settlement and bank cheque markets for cash gives them a pivotal role in the transmission of Reserve Bank actions to the wider financial community.<sup>2</sup>

The Bank trades with the dealers for two separate but related purposes. The first is to smooth ebbs and flows in the supply of banks' cash balances and, as a consequence, to dampen fluctuations in short term interest rates. These smoothing actions are often referred to as liquidity management. The second is to alter the supply of such balances in order to bring about changes in the prevailing level of interest rates in the markets for short term (overnight) funds. This then influences other interest rates in the economy and, ultimately, saving and spending decisions, economic activity and inflation. These are called monetary policy actions.

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#### 4. Reserve Bank Facilities

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To enable full effect to be given to their role in the system, the Reserve Bank provides dealers with a number of facilities.

The central pillar of any short term money market is liquidity. Those who lend their own liquid funds must be confident they can retrieve them at short notice. Those who invest in securities want to be able to unwind quickly their investments without incurring additional loss due to market illiquidity.

From the inception of the official market, the Bank has underpinned liquidity through the provision of a line of credit to the authorised dealers. Until recently this took the form of a "lender-of-last-resort" facility, where dealers were able to borrow from the Bank pledging Commonwealth Government securities as collateral.

In May 1989, the line of credit was changed to an end-of-day repurchase facility. Dealers

are expected to use the facility only after all reasonable efforts have been made to obtain funds in the market. The interest rate and term applying to repurchase agreements are set by the Bank. The term is normally seven days, though the Bank may offer other terms. Yields vary with market conditions but normally contain a penalty element.

Dealers also have access to the Treasury note rediscount facility which is available from the Bank to any holder of Treasury notes within 90 days of maturity.

Each dealer conducts a clearing account at the Reserve Bank, through which pass transactions with clients, with other dealers, and with the Bank itself. Funds deposited to this account receive immediate (same day) value which puts the dealers in a unique position to provide an interest-bearing repository for banks' cash reserves. When funds on loan are repaid to a bank, the proceeds again receive immediate value in the bank's exchange settlement account with the Reserve Bank.

Dealers are required to secure loans by placing with the lender (or with a third party acting on the lender's behalf) collateral in the form of selected money market instruments to at least the market value of the loan. Commonwealth Government securities form the majority of such collateral. To facilitate this process, dealers' Commonwealth Government securities are held in a special account at the Bank. The Bank then issues Acknowledgement Forms which dealers deliver to clients as collateral. The relevant Commonwealth Government securities are "reserved" by the Bank while the Acknowledgement Forms are on issue.

To help bridge differences in timing between the movement of funds and securities, the Bank allows dealers to overdraw their money and securities accounts for short periods during the day. Limits are placed on the extent of these **daylight overdrafts**.

The Bank also acts as **participating bank** for dealers' Austraclear transactions.

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2. See "The Reserve Bank's Domestic Market Operations", *Bulletin*, December 1990.

## 5. Supervision of Dealers

As part of their contractual relationship with the Bank, dealers agree to meet certain guidelines. These are designed to ensure that the dealers are managed prudently and have adequate capital and liquidity; and that the facilities of the authorised market are available widely for the benefit of the financial system generally, rather than solely for the benefit of a particular shareholding group.

### (a) Ownership

The ownership of a dealer must be acceptable to the Reserve Bank. Owners must have the capacity and willingness to commit resources to preserve the position of creditors and to maintain the capital of the company. They should be of good repute and market standing and be able to contribute to the direction and management of the company. It is important that dealers should operate independently from each other to ensure genuine market competition. To this end, owners may not have a substantial interest in more than one official dealer company. For similar reasons, and to see that the effects of the Bank’s market operations spread quickly to the financial markets as a whole, a separation is maintained between banks and authorised dealers. A bank may not be a direct shareholder in a dealer company and may only hold, indirectly, up to 12.5 per cent. A party with a substantial shareholding in a bank authorised to operate in Australia may not also be a substantial shareholder in a dealer company.

Chart 1 shows the ownership structure of the dealers as a group as at end May 1991. At their inception, dealers were owned mainly by individuals and partnerships. Over time, ownership has largely passed to institutions and now only one ownership structure is in the early form.

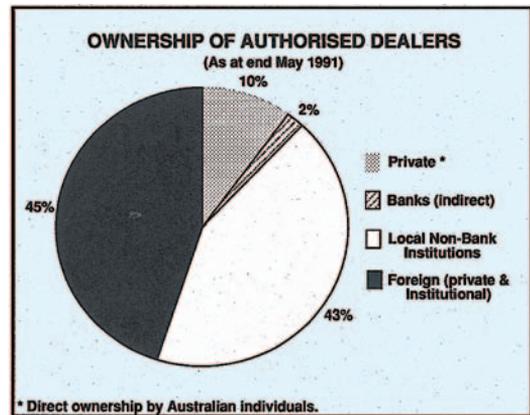


Chart 1

Over the years there has been an increase in foreign ownership, with many dealers now having substantial foreign equity. This reflects the relaxation and final removal of quantitative restrictions on participation by foreigners. The final step occurred in early 1990 with the removal of the 50 per cent limit on foreign ownership. This change brought the rules on foreign ownership of dealers into line with those applying more generally to the non-bank finance industry in Australia.

### (b) Capitalisation

In May 1989, the Bank increased the required minimum capital level of individual dealer companies from \$5 million to \$10 million. Capital is defined as paid-up capital, share premium reserves and retained earnings. Subordinated loans from shareholders are not counted as permanent capital but may be approved as a temporary means of supplementing the capital base for gearing purposes (see below).

The total capital base of the eight authorised dealers at end May 1991 was \$113 million.

### (c) Asset Structure

Dealers are subject to a “gearing limit”, i.e. the total assets they may hold is determined by the risk attached to the assets and the size of their capital base. Aggregate risk weighted assets may not exceed 33 times shareholders’

funds (including any subordinated loans approved for inclusion by the Bank for gearing purposes). Assets are weighted by period to maturity, with shortest maturities having the lowest weights. Adjustments are made for some commitments not reflected on the balance sheet, including those in respect of repurchase agreements, forward commitments and derivative products (futures contracts, options, etc). Basing risk weights on maturity reflects the sensitivity of the value of securities to changes in interest rates. The longer the period to maturity, the larger the capital loss occasioned by a rise in interest rates.

The main assets which dealers may hold are limited to highly liquid, low credit risk securities. These include Commonwealth Government securities, bank bills and certificates of deposit, and marketable securities issued by major public authorities. A dealer's aggregate holdings of non-Commonwealth Government securities are limited to 50 per cent of its gearing limit.

#### (d) Reporting requirements

The Reserve Bank monitors closely the activities of authorised dealers. They provide the Bank with a wide range of information on their operations. Much of this is supplied through regular statistical returns, some on a less formal basis.

Contacts between the Bank and the individual dealer companies are close and frequent. Formal meetings also occur at least twice a year with the Chief Executives of the dealers as a group.

## 6. Recent Trends

### (a) Assets

In terms of assets, authorised dealers are small relative to other financial groups. Table 1 shows that, at 30 March 1991, their assets totalled \$4.3 billion, around one per cent of the total assets of financial institutions in Australia. Their balance sheets also tend to be much more variable than those of other institutions, contracting and expanding in response to the ebbs and flows of liquidity in the money markets and the banks' desire to hold cash balances.

The bulk of dealers' assets – usually over half – is held in Commonwealth Government securities, principally short-dated Treasury bonds and Treasury notes. The remainder is primarily held in bank securities – bills and certificates of deposit. A small proportion is held in public authority securities. Chart 2 shows details.

**Table 1: Assets of Selected Financial Institutions**

*\$ billion*

As at	June 1985	June 1986	June 1987	June 1988	June 1989	June 1990	March 1991
Authorised Dealers	1.9	2.0	2.2	3.2	2.7	4.6	4.3
Money Market Corporations	22.6	29.9	38.3	48.7	53.0	52.9	48.9
Finance Companies	26.6	29.6	29.4	30.3	36.5	40.7	38.0
Building Societies	18.5	20.1	18.3	21.5	24.2	22.9	21.5
Other Non-Banks	13.7	17.2	21.8	25.0	23.8	23.5	23.5
Banks	120.2	151.2	182.7	226.3	283.7	325.9	349.8
Total	203.5	250.0	292.7	355.0	423.9	470.5	486.0

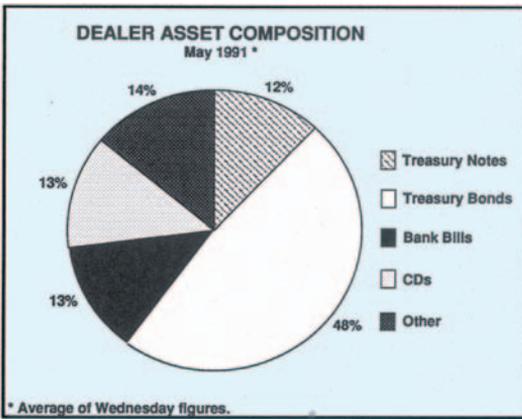
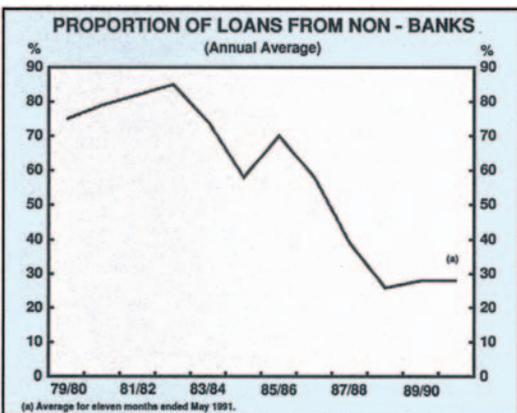


Chart 2

**(b) Sources of Funds**

Dealers borrow funds at call, or for fixed periods, in minimum amounts of \$50,000.

Until 1984, they typically raised 75-85 per cent of their funds from non-bank clients. However, many of these clients were lost to the banks following the decision in August 1984 to permit banks to pay interest on overnight and short term deposits. Nowadays, loans from non-banks form less than one third of the dealers' liabilities (see Graph 1). The bulk is overnight loans of exchange settlement funds by banks.



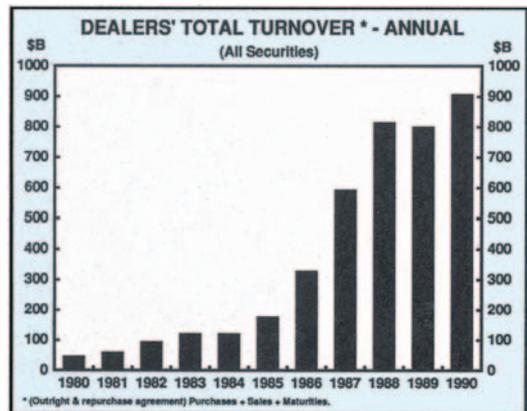
Graph 1

**(c) Turnover**

Dealers are active traders, some more active than others. On average, around two thirds of

the value of assets is turned over every day, but four dealers between them account for about two thirds of the total turnover.

Graph 2 shows that dealers' transaction volumes quadrupled between 1985 and 1988, from \$700 million a day to around (3.2 billion). Turnover has subsequently stabilised around this higher level. The main factor in the higher turnover has been the trade in **repurchase agreements (RPs)**. In August 1986, the Reserve Bank allowed dealers to buy and sell securities under RP with banks and other clients; this had not previously been possible.



Graph 2

Under a repurchase agreement, a trader buys (or sells) a certain amount of securities and agrees to a reverse transaction for equivalent value at a specified future date at an agreed price. It can also be called a spot/forward swap.

RPs are different from a loan of securities or the type of buy-back common in the 1950s, since ownership of the securities legally changes hands. RPs increase the effective stock of Commonwealth Government securities available for trading in the money market by enabling longer-term bonds to be used for short term trading without purchasers having to carry the full risk of large swings in capital values as yields change.

RPs now account for about 60 per cent of dealers' transactions. Recently there has also been some growth in RP transactions based on securities of public authorities.

“Single-leg” trading of Commonwealth Government securities now accounts for only a little over one tenth of total trading activity. For non-Commonwealth Government securities -mainly bank bills and securities of public authorities – outright trades account for around one quarter of turnover. Chart 3 shows the composition of dealers’ trading activity for 1990.

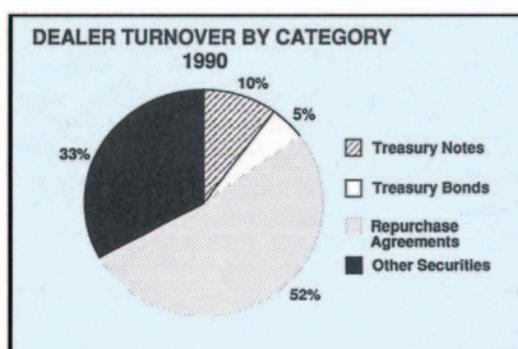


Chart 3

## APPENDIX A

### LIST OF AUTHORISED SHORT TERM MONEY MARKET DEALERS

*As at May 1991*

All-States Discount Limited

Colonial Mutual Discount Company Limited

FBA (Discount) Limited

F.R. Australian Discount Limited

Potter Warburg Discount Limited

Rothschild Australia Discount Limited

Schroders Australia Discount Limited

Short Term Discount Limited

## APPENDIX B

### COLLECTIONS OF STATISTICS OF AUTHORISED SHORT TERM MONEY MARKET DEALERS

The main collections of statistics on the operations of the authorised short term money market dealers published by the Australian Bureau of Statistics are:

- ***Authorised Dealers and Money Market Corporations, Australia (Catalogue No. 5638.0)***

This was a monthly publication first issued in June 1984; the final issue was published in December 1989. Data for subsequent months are available on request. The data cover selected liabilities and assets, maturity categories of selected liabilities and assets, and liabilities to clients, by type.

Tables C.3 and C.12 in the Reserve Bank *Bulletin* provide similar data which are sourced from returns submitted by the dealers to the Bank.

- ***Authorised Dealers and Money Market Corporations: Assets, Liabilities, Income and Expenditure, Australia (Catalogue No. 5650.0)***

This is an annual publication first issued for the financial year 1984/85. It shows type and amount of assets and liabilities, types of income and expenditure, and appropriation of profits.