

Foreign Banks in Australia

Talk by the Governor, B. W. Fraser, to the Overseas Bankers' Association of Australia, Melbourne, 17 August 1994.

It will be ten years next month since the Government invited banks around the world to express an interest in acquiring an Australian banking authority. That process led to the first wave of foreign banks in the mid 1980s; it was to be followed by the second wave – a ‘wavette’ really – which is now occurring.

I would like to offer a few observations on the operations of foreign banks in Australia.

Mid 1980s Policy Change

That decision ten years ago was quite a brave one. The Bank of China had been the last foreign bank to get in under the wire, opening a branch in Sydney in 1942. During the intervening period of more than forty years, it was bipartisan policy to exclude foreign banks from operating as banks in Australia.

The change was one of a string of quite brave decisions at that time, their boldness little diminished by the ring of inevitability surrounding many of them. This was the era when Australia was at last emerging from its insular, protectionist pouch, and beginning to

find its feet in a big and competitive world. The financial sector was leading the way in this process; exchange controls had been lifted and the exchange rate floated, and controls on interest rates on both loans and deposits were being removed.

Foreign banks, of course, were not without some influence in Australia before this time. As early as the 1960s, many had established operations in Australia as what are now known as merchant banks. By 1974, 60 per cent of the paid-up capital of such institutions was owned by overseas banks. Today, the assets of merchant banks owned by foreign banks total \$38 billion, while the assets of authorised foreign banks are somewhat larger at \$47 billion. Taken together, foreign banks and foreign bank owned merchant banks account for around 16 per cent of the Australian assets of all financial intermediaries operating in this country.

The main spin-offs from foreign bank entry were seen as increased competition (with the new players introducing leading edge banking services and techniques) and improved access to international capital markets. By and large, these potential benefits have been realised. Australia now has a very competitive, internationally integrated banking system. The threat of competition itself was sufficient to stir the domestic banks to considerable activity, even before the foreign banks arrived.

There could have been few doubts in the minds of Australian corporates and

'entrepreneurs' in the late 1980s about the spur to competition which came with the foreign banks. During this period, domestic and foreign banks were falling over themselves as they chased prospective customers. Throughout the second half of the 1980s, business credit was easily the fastest growing component of total credit, expanding by close to 25 per cent per annum. We all know now how unsound the fruit of much of that borrowing frenzy was.

Without seeking to apportion blame in that episode, I think it is legitimate to question whether any sustained rapid growth in lending – be it business credit in the late 1980s and housing credit in more recent years – is driven entirely by demand factors. There is always a suspicion that part reflects commission-driven efforts of eager salespeople operating in a fully deregulated environment.

The possibility of deregulation going too far or too fast was not among the (mainly xenophobic) arguments against admitting foreign banks which were canvassed before the Campbell and Martin Committees. But even supporters of deregulation will concede that there can be too much of a good thing, and that additional prudential supervision, for example, might be necessary to retain the benefits of a competitive financial system, or that unfettered financial market activity might sometimes need to be checked in the interests of broader economic and social objectives. I think these views are more respectable today than they were a decade ago.

At the time foreign bank entry was being debated, the issue of economies of scale figured prominently – on both sides. Foreign banks were seen innately as having economies of scale which would make them immediately competitive with major Australian banks. The downside was that these potential cost advantages might be so large as to render the foreign banks too competitive for the locals. In the event, the major Australian banks had to work hard but they successfully defended their retail businesses. The experience of the past decade confirms that winning over a critical mass of retail customers in a foreign country is an extraordinarily difficult – if not

impossible – task. For most banks, the only real prospect would be to buy that critical mass, through the purchase of a significant Australian retail bank.

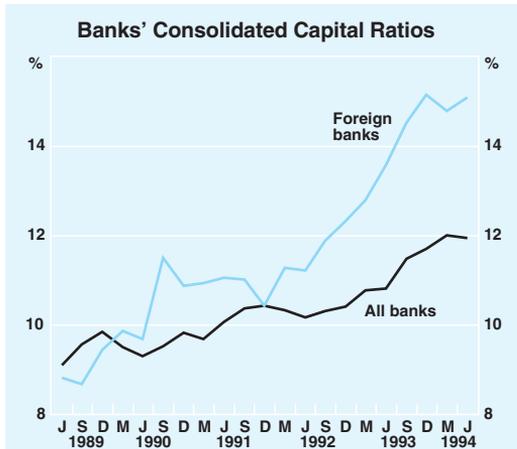
Various strategies and market niches have been explored by foreign banks, with some spectacular successes (e.g. in funds management and corporate advice), and some equally spectacular failures (e.g. in retail banking). The relative contributions of the foreign banks to the foreign exchange market, the derivatives market and funds management are much greater than their share of Australian assets of financial intermediaries would suggest.

So much for a quick look at the past. At the present time, the environment – for domestic and foreign banks alike – is more settled than it has been for a decade. This, of course, is cheering to a central banker, because a strong banking system contributes to a strong economy, as well as being more resistant to prudential problems.

The capital positions of the banks – the first buffer against unpleasant shocks – are robust. The average capital ratio for the Australian banking system in June 1994 was close to 12 per cent, compared with 11 per cent a year earlier, and well above the 8 per cent minimum requirement. Foreign banks operating in Australia made losses equivalent to around one-third of their equity base in 1990, but the support of parent banks and changes in strategies and scales of operation have been such that their average capital ratio is now around 15 per cent, well above that for the banks as a whole (see Graph 1).

The Reserve Bank's new guidelines for the public reporting of bad loans becomes effective next month. Somewhat ironically, if nonetheless happily, this problem has diminished dramatically while the measurement questions were being resolved. For the banking system as a whole, non-performing loans, as currently measured, have declined from a peak of close to \$30 billion in March 1992, to \$23 billion in June 1993, and to \$13 billion in June 1994. As a percentage of assets, the fall has been from a peak of close to 6 per cent to

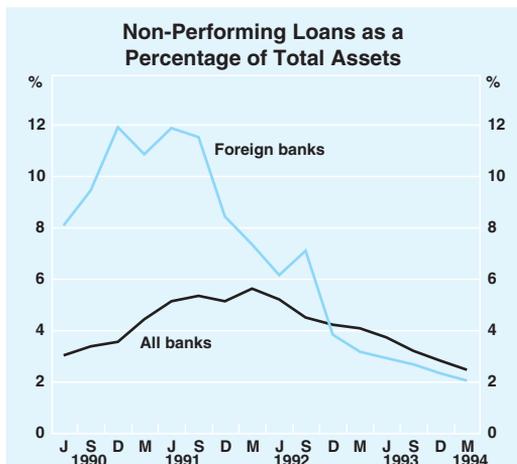
Graph 1



2.3 per cent in June 1994. The new and more rigorous definitions to apply from September are likely to generate slightly higher numbers than the current definitions, but the underlying downward trend will remain.

For foreign banks, the improvement in loan quality has been particularly pronounced. Our regular consultations with individual banks are now punctuated by reports of office blocks, hotels and other previously unwanted assets moving off the books of banks to new owners. The non-performing loans of the foreign banks peaked much earlier and at much higher levels than they did for local banks, reaching close to 12 per cent of assets in late 1990, three times the average for the system as a whole at that time. By late 1992, the ratio was back in line with the system average and, at

Graph 2



just over 2 per cent, it is now a little under the system average (see Graph 2). This progress was only possible with the help of some very understanding parents.

February 1992 Policy Change

In February 1992, the Government opened the door to additional foreign banks to operate as authorised banks in Australia, and the option of branch banking status was made available (including to foreign banks already operating here as subsidiaries). The first wave of foreign banks was restricted to subsidiaries, so that, *inter alia*, they would be subject to Australian law and prudential standards, and operate on the same footing as domestic banks. From a supervisory perspective, locally incorporated banks, with their own capital in Australia, were seen to be preferable to branches which, for all intents and purposes, were indistinguishable from the parent foreign banks.

As with the change in the mid 1980s, the latest move was motivated fundamentally by a desire to increase competition in the banking sector. On this occasion, however, the expectations as to where that competition might occur were somewhat more limited. Although the policy changes provided for more retail orientated banks to be opened as subsidiaries, experience suggested that any increased competition was likely to be concentrated in treasury activities and corporate lending, rather than in retail or comprehensive banking services.

It was recognised at the outset that the competitive bonus from this change was likely to be modest. We accepted the argument by foreign banks that the benefits of operating with the capital resources and ratings of their parents would permit branches to perform more competitively than subsidiaries (which were required to hold capital in their own name, and to operate under certain other constraints). Some additional foreign bank branches might, therefore, sharpen

competition in the non-retail sector but the gains were likely to be marginal rather than spectacular.

Even those potential gains would depend very much on the value added by the new branches. That is why the granting of additional authorities was made conditional upon, *inter alia*, branches adding depth to an existing market or developing new niche markets. In other words, we expect prospective applicants to be in a position to add something of significance and permanence to the Australian market. We do not see much point in handing out banking authorities to institutions to book business on behalf of overseas offices, or to sell head office products, or to do what they might already be doing in Australia as merchant banks.

Fine judgments will sometimes be required about what is and is not acceptable in particular cases. I can perhaps give one indication of our general thinking by reference to the tendency in recent times for foreign banks (and some non-bank foreign exchange dealers) to locate parts of their administrative and trading activities offshore. While we might prefer otherwise, we have acquiesced in decisions which involve transactions originating in Australia being processed through computer houses in offshore 'Regional Processing Units'. We have been relatively relaxed about this because such activities are routine and involve no significant risks for Australia, and we recognise that there may well be important economies of scale for the banks concerned.

Of more significance have been the decisions of some institutions to centralise parts of their foreign exchange trading – mainly third currency business – in other countries of the region, and to close that part of their Australian operations, even though a good and profitable business might have been built up here. Such decisions have been disappointing to us, and they have diminished the Australian market, but again we have accepted them as the considered commercial judgments of the foreign banks concerned.

Nevertheless, some of these decisions are perplexing, given Australia's very competitive

cost structure and skills base these days. The cost of office space in Sydney, for example, appears to be about a quarter the cost in Hong Kong and Tokyo, and below that in Singapore. If current tendencies towards regionalisation by banks were simply a response to commercial considerations, it would not be unreasonable to expect some of this activity to be coming Australia's way, as it is in certain other areas.

Where we have drawn the line on proposed relocations of activities to regional headquarters is on what we see as essential elements of the banking process, such as settlements. This is an issue of risk control. Australian managements must be responsible unambiguously for a branch's entire Australian operations, and be able to report directly to the Reserve Bank on those operations. If parts of a bank's Australian operations were to be rolled into operations located elsewhere, the lines of responsibility would become very difficult to disentangle. For this reason, the Reserve Bank has not approved proposals to relocate the settlements function of foreign branches (or foreign exchange dealers). Any approach to move the administration of other essential aspects of Australian branches' business would be treated similarly.

Eight banking authorities have been issued under the 1992 guidelines, including three which received authorisation as locally incorporated subsidiaries during the 1985 intake (see Table 1). Applications from a number of other banks are at various stages of processing.

As everyone knows now, taxation issues have delayed and complicated the applications of more than a few branch aspirants. They have also complicated matters for the Reserve Bank. This is a little ironic, because I well recall that taxation issues were not raised in any prominent way at the time foreign banks were making the case for branch status, in the lead-up to the revised policy statement in February 1992. If taxation issues were in the minds of any of the advocates at the time, it must have been presumed that they would somehow be resolved along the way.

Table 1: Banking Authorities Granted Under the New 1992 Guidelines

Bank	Commencement date	Total assets (\$m, June 1994)
Bank of America NT & SA*	1 July 1994	675 (e)
Barclays Bank Plc*	6 April 1994	2,095
Credit Suisse	1 May 1994	593
Deutsche Bank AG*	1 July 1994	2,066 (e)
NBD Bank NA	1 July 1994	275 (e)
Overseas Union Bank Limited	3 May 1993	243
State Street Bank & Trust Company	17 January 1994	355
United Overseas Bank Limited	1 September 1993	257

* Banks which received authorisation as a locally incorporated subsidiary during the 1985 intake and which have now converted to foreign bank branch status.
(e) Estimated.

Interest Withholding Tax (IWT)

The major taxation issue has been interest withholding tax. Interest derived by non-residents is subject to Australian withholding tax, to the extent that the interest is an expense of an Australian business. An exception to this general rule arises under Section 128F of the *Income Tax Act*, which provides for an exemption from IWT for interest on borrowings raised outside Australia by Australian resident companies by means of public or widely spread issues of securities.

For some banks, it has transpired that these arrangements can disadvantage branches *vis-à-vis* subsidiaries. A lot of lobbying for the removal of IWT followed this discovery. For the Government, it was a question of weighing up the potential loss of significant amounts of revenue against the facilitation of additional foreign bank branches. In June 1993, the Government announced that it would, in effect, exempt half of the interest on intra-bank borrowings from IWT; the legislation to implement this change is currently before the Parliament.

The Reserve Bank requires that, unless there are good reasons to the contrary, foreign banks

operating in Australia through branches should conduct the bulk of their financial intermediation through the branch. This requirement also has come up hard against the IWT issue and the Bank, too, has compromised in the interests of facilitating the entry of more branches and more competition in Australian banking.

In December 1993, the Bank announced that it would accept access to Section 128F funding from abroad as a sufficient reason for intermediation business to be undertaken within a non-bank subsidiary, rather than in the branch. In the resultant model, the branch would conduct foreign exchange and other business which does not require much funding while a non-bank subsidiary would conduct most of the lending using Section 128F exempt (and, therefore, lower cost) funding. From the point of view of a prudential supervisor, such bank/non-bank hybrids are very much compromise solutions.

Still the lobbying goes on. Some of this is directed towards the complete removal of IWT. This is essentially a matter for the Taxation Office and the Government. The Bank considered the earlier decision to exempt half of the interest on intra-bank borrowings from IWT as a reasonable compromise in the circumstances; given that, and given my oft-stated desire to see the budget deficit

reduction program accelerated if possible, I am hardly in a good position to support complete abolition of IWT (and the loss of several hundred million dollars of revenue) at this time.

As to suggestions that the Reserve Bank should allow other forms of offshore borrowings (besides Section 128F borrowings) and intermediation to be conducted indefinitely in a non-bank subsidiary, rather than in the branch, I have to say that we remain to be persuaded. If a branch is to be established, it does not make a lot of sense to me to be constantly relaxing the 'bulk of intermediation' test to get around taxation and regulatory difficulties in particular countries so that more business in Australia can be done outside the branch in the non-bank subsidiary.

There is no cut-off time for foreign banks to decide whether they can benefit themselves and Australia as authorised branches, and to apply for branch status. My own hunch is that the present steady line of enquiry from foreign banks interested in setting up branches in Australia will continue. This hunch is based on the belief that, over time, the benefits of Australia's comparatively lower costs and its integration with the Asian region will become more compelling.

Derivatives

Foreign banks have been important players in Australia's derivatives markets, and branches in particular are likely to concentrate their business in treasury products, including derivatives.

This audience will understand that, properly used, derivatives can help to improve the management of risk. But they can also increase exposure to risk, either deliberately in the case of position taking for speculative purposes, or inadvertently through a lack of understanding of sometimes complex products.

The Reserve Bank is seeking to assure itself that banks are properly managing the risks

involved. Banks already are required to hold capital against the credit risks involved in derivatives, and you will be aware of the Basle Committee proposals for market risks (including those from derivatives) also to be included in the capital framework. Although foreign branches will not have to hold capital in Australia, they will be caught up in the global capital calculations of their parents.

In addition to holding capital as a buffer against possible losses, banks need sound systems to measure and control the risks associated with derivatives. In this connection, the Basle Committee has stressed the importance of:

- effective oversight of risks by a bank's board and senior management;
- adequate measurement, monitoring and limitation of risk; and
- thorough audit and control procedures.

The Reserve Bank's own survey of risk management practices of Australian banks suggests that banks generally have made good progress in developing their systems to a generally high standard. But there will always be scope for improvements, and as well as continuing to monitor developments in this area, we are planning visits to banks to discuss their derivatives activities; a particular focus will be the possible use of banks' own systems for the calculation of required capital to be held against market risks. I am pleased to acknowledge that the banks have readily co-operated with us in similar visits in the past, and I trust that this co-operative spirit will continue.

Bank Directors

Finally, a few words on the role of independent directors on the boards of banks, be they foreign or domestic. It is the ultimate responsibility of the board of a bank to see that the bank operates in a sound and prudent manner. A board may delegate authority to senior management for the bank's day-to-day operations, but it should bring an independent

and questioning approach to the management of a bank. As a general principle, we believe that is more likely to occur where a majority of the directors and the chairman are independent of management (i.e. are non-executive directors).

In addition to their responsibilities to shareholders, bank directors have a responsibility to depositors. Where banks are operating as subsidiaries of foreign banks, we are prepared to accept that executives of the overseas banks can act as non-executive directors of the Australian subsidiary. Our preference, however, is that at least two directors should be independent of the shareholder bank.

Such a requirement was included in a draft guideline which we circulated earlier this year for comment. It elicited some sharp responses, principally from foreign banks who argued

that directors of a subsidiary cannot have a view independent of its global entity. It was also argued that it would be unfair to independent directors to put them in such a position.

Those arguments do not, in my view, give sufficient weight to the fact that an Australian subsidiary is a separate bank in its own right, and not a branch of the overseas parent. The policy of a subsidiary will necessarily be set by the overseas parent, but it is reasonable that there be some independent minds on the board prepared to speak up, should it be necessary, for the interests of the local depositors. While the independent directors will usually be in the minority and can be outvoted, in extreme cases they may well take more radical steps, such as resigning and explaining their positions to the central bank. I see nothing wrong in that situation.