Foreign Banks in Australia : A Strategic Reassessment

By Robert A Ferguson

TO discuss foreign banks in Australia, one needs to look at what has occurred in the 1980s in the financial sector in Australia. The foreign banks were, to a large extent, like corks bobbing on the surface of financial change. Inevitably then, their overall performance was very much a function of the sea of change that was going on around them.

Change became the norm in the eighties. In the financial sector, the underlying force of this change was deregulation. Fuelling these forces was the persistent and escalating influence of technology which both forced and facilitated financial deregulation.

The impact of deregulation can be likened to the elimination of a low speed limit on a highway. While it is predictable that such an event could cause an increase in traffic accidents, it should allow people to go about their business more efficiently and after a short time the drivers should adjust to the increased freedom and the number of accidents should go down again.

It is, therefore, no surprise that deregulation has produced a rash of corporate collapses and large banking losses.

It is widely recognised that the most obvious result of deregulation has been the unprecedented use of credit which proceeded on an escalating basis throughout the eighties. Initially, with inflation still at 12% in 1982 and interest rates at similar levels, the resort to credit reflected the common sense approach (adopted by many during the seventies) of gearing up when real interest rates were low or negative. But after 1983, our inflation and interest rates moved in opposite directions thus restoring the high real interest rates we had seen at the start of the decade.

Between 1983 and end 1988 business credit expanded at an average annual rate in excess of 25%, while nominal income grew on average at no more than 12% per annum. It wasn't as if this expansion of credit was based on its relative cheapness. Between end 1983 and end 1988 real interest rates more than doubled from 3.0% to 6.5%, as inflation slowed and interest rates continued to rise.

What was it that made business so keen to gear despite the escalating cost?

The first answer is availability of money. Deregulation meant the Central Bank rationed debt by price and not quantity. In addition, the arrival of sixteen new competitors on the banking scene from 1985 and the cracking pace they set, prompted a highly competitive banking environment. Under these circumstances banks, to their present regret, began allocating credit without due regard to risk. In other words, spreads between prime and lesser credits were far too narrow.

To return to my highway metaphor, in a regulated environment with credit rationed via monetary policy, banks were denied the opportunity of exceeding the speed limit by governments and thus inevitably doled out their quota with quality in mind. Then once the speed limit was lifted, driving quality at the higher speed deteriorated. And so it was with inexperienced risk assessors lending on a price basis.

But availability of credit is just one side of the coin. Why did business gear up in the face of increasing real cost of money? To some extent it may have been a habit established when it was wise to do so in the seventies, but it also reflected the efforts of bankers and advisors in the new competitive environment to demonstrate, via technology, the benefits of the tax system's bias against equity.

Initially there were excellent rewards for entrepreneurs who geared to acquire sleepy companies. This process focused on full tax-paying, undergeared companies. The penny dropped after the Bond Corporation bid for the Castlemaine Tooheys Group in 1985 when, at face value, it seemed a very high price earnings multiple had been paid. From then on, pricing power in the stock market began to move out of institutional investors' hands into those of the entrepreneurs whose gospel was private company value. At its extreme, this became a euphemism for infinite leverage. Then debt free, full tax-paying corporates became worth almost twice their stock market value as their new owners were able to offset their tax liability by leverage and tax sheltering techniques.

Once pricing power was in the entrepreneurs' hands, the arbitrages began to diminish. But profits, if not value, were still to be found in the booming stock market that hung on every word uttered about the entrepreneurs' intentions. The entrepreneurs kept buying, dealing and raiding, as lenders continued to facilitate their expanding asset bases. This activity flew in the face of the maturity of the long bull market.

Another feature of this period was a diminishing respect for the concept of an equity cushion. This was mainly caused by the extended economic expansion that began in 1982. The further the expansion went the greater confidence rose in the ability to cry "Look, no equity". At its extreme, this process saw borrowers argue with lenders that the equity implied by any share market premium over shareholders' funds should be regarded as bankable goodwill. This view was valid only if supported by strong and growing cash flow.

Along with the prolonged economic cycle, there was another feature of the real economy that encouraged a complacent attitude towards the equity cushion. This was the fact that via the process of credit rationing moving to price not quantity, volatility was transferred out of the real economy into the financial economy. To be sure, the real economy has featured the ups and downs of various sectorial recessions in agriculture, mining, real estate, oil and now financial services, but in total we have been spared the co-ordinated slowdowns of a regulatory credit rationing that produce sharply negative periods of aggregate economic activity.

Thus with the overall economy chugging along, economic volatility seemed to have become less of an issue. As it transpired, the volatility had not disappeared, but had been transferred to the financial sector via interest rates, currencies and share prices.

The financial sector became a shock absorber of the real economy. For those who geared in anticipation of less real economy volatility and a repealed business cycle, the bubbling up of financial sector volatility, predominately via share prices and short term interest rates, usually proved fatal.

The permissiveness of bank lending post-deregulation was accompanied by reduced controls on the borrowers once money was lent. Negative pledges replaced security. Borrowers justified these concessions on the grounds of flexibility for the borrower plus the reduction of stamp duty costs. Banks, under competitive duress, usually gave in to these pressures. Change in ownership clauses were also weakened or eliminated in this competitive process. Yet on reflection, a period of great takeover activity was precisely the time these provisions needed tightening.

Lending practices pre-deregulation reflected long periods of marginal change and limited competition. This prompted close relationships and trust between lenders and borrowers. Many of the new borrowers had no experience or respect for these relationships. So as either new borrowers or new controllers of vehicles with long standing credit lines, they often abused the level of trust that banks had grown used to according borrowers.

The entrepreneurs have now almost disappeared from the scene. Their brief period of supremacy was costly in terms of debt and equity losses and business upheaval, but there was still net benefit in their role in introducing competition into our corporate world. Deregulation and globalisation necessitated a re-shaping of our system. Privileged groups had prospered behind national barriers and the elimination of their elevated status was imperative. The entrepreneurial era achieved this.

Dr. A.M. Wojnilower, US Economist, has observed that:

"We have entered a world in which every developed country has to become more specialized in its production. To compete, a tradeable product must be able to attract a significant share of the world market. This is forcing the restructuring, or worse, of many major industries or enterprises.

Chronic losses, erosion of equity and eventual bankruptcy would have been the traditional means of adjustment. Debt financed takeovers and buyouts are smoother and faster. They are an effective way to 'bribe' normally recalcitrant top management and shareholders to accept prompt retrenchment, as well as to enable them to override the opposition of middle management unions and other workers."

How are the banks, both domestic and foreign, responding to the problems thrown up by the bankruptcy phase we are presently in? The big issue is, of course, negative pledge lending. Recent court decisions have shown that the courts are obsessed with legality rather than the commerciality of a negative pledge relationship. Effectively the courts have decided that breaches in covenants are not sufficient to warrant the appointment of a receiver while interest is still being paid. Covenant breaches have been seen as appropriately handled by the injunction process to stop breaches.

The way the banks are responding to this varies with the creditworthiness of customers. In relation to poor credits, banks are tending to show no sympathy for the stamp duty costs of assuming a secured lending role. For better credits the banks are avoiding the fixed and floating charge route but toughening up on cash flow covenants with the writing in of minimum interest cover ratios. Also they are putting restrictions on the composition of assets outside the main business.

The logic here seems to be that a cash flow breach should be regarded by a court as a clear event of default. Furthermore, cash flow ratios are rather unforgiving in that they pick up any non-performing assets both in or out of the mainstream business and they also pick up any deterioration in the underlying business.

The fact that the banks are prepared to compromise with large corporates on this issue ultimately reflects the balance of power in their relationships. Beneficiaries of this tend to be corporates who are good enough credits to be regarded as quality borrowers in the flight to quality phase we are now going through.

So where did the foreign banks fit into the deregulation phase? What was their purpose? Did they fulfill that purpose? Where did they go wrong? What is their future? Foreign banks were the cannon fodder of deregulation. It was their role to create competition. But they were like front line troops sent to attack the formidable bulwarks of oligopoly and entry barriers set up by the incumbent domestic banks.

Like most front line troops, the foreign banks never really had a chance to succeed. The big 4 incumbent banks had plenty of warning of their arrival and thus had set about preparing for the onslaught. I remember that for the Westpac/CBA and NAB/CBC merger, the rationale of CBA an CBC that with their respective market shares of 7% and 8% each they did not have the critical mass to survive deregulation. Thus they merged and the result was Westpac ended up with a market share of 32% and NAB 25%. It is ironic that in 1982 CBA and CBC were saying less than 10% market share was inadequate in the retail market but three years later the foreign banks set about starting from scratch. I am sure none of them would have dreamed of being able to achieve 10% market share for decades. So in a sense their whole strategy was repudiated by experts in the market, that is their competitors, three years previous to their entry. Clearly the foreign banks were oblivious to this vital strategic input. In retrospect, the only way that a foreign bank could have made an impact in retail would have been to be in position to acquire the market shares of either CBA and CBC when they were sold in the early 80s. Such an acquisition would have at least given a base to build upon.

The other way the incumbents prepared for slaughter of the innocents was to raise the barriers to entry. So in 1986 Nobby Clark announced, the NAB was spending over $800 million over six years on upgrading of systems in NAB's 1500 branches.

So it is clear that by virtue of their entrenched positions, their preparedness via mergers and spending on raising entry barriers, the big 4 incumbent banks were very comfortably sitting behind remarkably high entry barriers by the time the foreign banks came on the scene in 1985. What areas did the new entrants try to compete in and where did they go wrong?

The five areas targeted were retail, high net worth, medium sized corporate, corporate and finally capital markets.

In the retail market few of the foreign banks were prepared to compete head on with the incumbents as they were daunted by the huge barriers to entry and the very long lead time before profits would emerge. Exceptions were Chase AMP and NML-Royal which both made a bold entry into retail. Both these organisations entered with a flourish but in different ways. Chase AMP sought to build a business anew. New branches and massive advertising for credit card customers while NML-Royal tried to build on a cheaply acquired market that came out of the clever acquisition of United Permanent Building Society. Other banks that tried a retail strategy were NatWest, Barclays and Citibank. Essentially all of these strategies have had limited success with Citibank doing best with a piggyback retail strategy using other peoples' distributions. The impact made has been marginal and most of these players are stuck in no-man's land with insufficient market share and an inability to know what to do next. The one player that has really fallen on its feet in this process is NML-Royal Bank. It invested $140 million in February 1986 and increased its investment to $271 million in September 1988. Its recent sale to ANZ realised $400 million. This produced a 64% return on the average capital invested in that four year period and a 12.6% annual return. You would probably have to say that now that it has departed, NML-Royal Bank's foreign bank strategy proved one of the most successful.

Of course the obvious attraction of the retail area was the possibility of free deposits. As we know, the big 4 incumbents currently still get over 20% of deposits interest free. This probably costs, via the collection process through the branch network, 7% at current interest rates. So it's nice business if you can get it. It is quite amazing that despite all the competition in the retail area over the last 10 years so much money persists in free deposits. The significance of this is emphasised by the fact that for the major private banks, if you deduct the return earned on shareholders' funds and the return on free deposits (after allowing for the cost of gathering those free deposits) the sum of these two figures exceeds total pre-tax earnings. So the incumbents' whole franchise is based on their free deposits. If a new retail competitor fails to get a share of those free deposits, he must fail. So it's little wonder that the incumbent banks fought so hard to protect their retail deposit bases.

As for high net worth retail, this market, while small, saw a fair amount of new competition. This was logical due to the potential for good margins, the relative city-based concentration of the target market, and the service orientation of such a market. Macquarie Bank and Citibank, amongst others, all have strategies for this area and should make an impact, but due to the small market size and the labour intensity involved in dealing with high net worth individuals, it doesn't amount to much in the scheme of things.

Next we have small to medium size corporate business. After the disastrous experiences of Australia Bank, other banks made a rapid retreat from this area. This is a sector where the margins are seductive but illusory due to the potential for major losses.

It is here that the big 4 incumbents are extremely well entrenched. They have the branch network to win business and via the Branch Bank Manager being close enough to his customer to be able to have a beer after work with him, he is able to keep a close eye on the progress of his loan. New entrants without a branch banking infrastructure had none of this. The new banks suffered the disadvantage of starting off with an unbalanced portfolio of incumbent bank rejects and this raised the potential for big loan losses. The early birds like Australia Bank learnt this bitter lesson to such an extent that this niche is probably the least attractive to the foreign banks now.

The corporate market ultimately saw most of the competition from foreign banks. This competition came despite the severe competition disadvantage that new banks operated under until 1989 via Statutory Reserve Deposits or SRD's. SRD's added roughly 1% to the cost of a loan and the incumbents were able to cross subsidise via their free deposit base. The new banks had no such luck and so in order to recoup the cost of doing this business, sought high margin loans. This led to their horrendous bad debt experience and forced to lower credit standards in seeking these margins. This explains why the foreign bank bad debt experience was so much worse than that of the incumbents. They were forced by their lack of subsidy from free deposits to chase higher margin, lower quality business.

The final market niche is capital markets. This is the much sought after area of fee and trading income. This was the market that most of the new entrants targeted but again had minimal impact in. The main problem new entrants had here was the massive cultural differences between the commercial bank and a successful capital markets group. You cannot simply change your spots from being a commercial bank frustrated by entrenched competition and huge entry barriers to becoming a capital markets bank. Essentially, commercial banking is asset driven while a capital markets group is driven by origination, trading and distribution skills. It has taken many years at Bankers Trust to acquire these skills and there is a delicate balance between earning fees and booking assets. It's much easier to book assets and many so-called capital markets groups amongst new banks never came to grips with this dilemma with the result that they suffered large loans losses under the guise of innovative capital market transactions.

In addition to the difficulty foreign banks had in Australia with the entrenched competition, there is another factor that doomed them from the start. This is the fact that most banks which came to Australia did so as part of a reluctant world wide globalisation effort that was based on a defensive mentality rather than an aggressive strategy. Banks have tended to globalise not because they saw good business opportunities but because they felt they must follow their customers overseas or lose their best customers to foreign banks. Such loss would threaten their domestic base.

For most global banks, with the exception of American banks, the home base is worth protecting. This is because, outside the US, most global banks operate in oligopoly markets, similar to Australia's banking market that over the years allowed these now enormous financial institutions to grow. Thus they were protected by their size at home but felt threatened by globalisation and felt obliged to go international even though they were going out into new markets where local oligopolies were extraordinarily well entrenched. So we had banks which had done well at home by virtue of market domination and history rather than talent but probably oblivious to their limitations in coming to Australia to teach the locals a thing or two. I can't imagine a better recipe for failure; sending an oligopolist into an oligopoly banking market like Australia's to try to start a green fields banking operation.

What is the future for foreign banks? Of the sixteen foreign banks operating in Australia, I believe approximately half will be gone within five years. We have already seen the demise of NM - Royal but this was for special reasons. First it was a joint venture and joint ventures in banking don't work. Second it is part of a bigger deal between NM and ANZ.

Whether the other banks remain in Australia or not will be determined by how well their global strategies fit the country scene.

Australia is a regional banking market rather than a global banking market. I believe Northern Hemisphere banks will increasingly question the need to be involved in low return regional markets such as Australia. Given the near impossibility of them making a return in Australia and the mounting pressure on many Northern Hemisphere banks in their home bases from loan losses, I believe most Northern Hemisphere banks will ultimately withdraw from Australia.

There are one or two exceptions - Bankers Trust and Citibank amongst American banks. Citibank has done reasonably well in Australia, in part reflecting that it is not part of a US banking oligopoly and therefore has been able to compete more effectively here. Also Citibank worldwide, in contrast to most other international ba-

→ 33

—> 7

ning in this respect, but it is only the beginning, and much more needs to be done in the years ahead. ■

MARK BOLÉAT is Director General of the Building Societies Association of the UK and was, until recently, editor of Housing Finance International.

—> 28

sustainability and viability of the environment of planet Earth. In a similar conference held earlier in Stockholm, Sweden in 1972, the planning, organization and management of human settlements was the subject of priority discussion and was the occasion where the "poverty is pollution" phrase was first used. While the Conference produced important measures for human settlements improvement and financing unfortunately these have not been pursued. Perhaps Rio in 1992 will produce new sparks for international action for this sector. ■

NOTES

1 Housing Finance International carried a full report by Mark Boléat in the August 1990 issue .

This is the text of a report presented by Luiz Eduardo Pinto Lima, Chairman, Housing Finance Development Committee of the International Union of Housing Finance Institutions at the Asia Pacific Federation meeting in Bangkok in September.

—> 11

nks, has been able to develop very profitable regional operations, with Latin American and Asia being the best examples. Again I believe this reflects its lack of local oligopoly dragging down its competence away from home base.

Another Northern Hemisphere exception might be Deutsche Bank, mainly because it does not seem to be under any great pressure at home due to both the relative strength of its oligopoly its East European opportunities. The main group of banks that I believe will stay can be classified as ones within our region, the Japanese banks, Hong Kong Shanghai Bank, Bank of Singapore, Bank of China. There is some regional logic to these being here and many of them are under less pressure at home when compared to the Northern Hemisphere banks. In addition, Asian banks as a generalisation seem to be more patient than their Northern Hemisphere counterparts. The will need to be! Nevertheless as a group, the foreign banks will be a totally insignificant force in the future.

Did the foreign banks serve a purpose? There is little doubt that they served their role as stimulants to competition, but now that most have fallen by the wayside, it is apparent that there is a danger of the oligopoly increasing its power. This is well illustrated by the posturing by NAB for control of the ANZ prior to the last election and the Treasurer's disapproval of this idea. What the Treasurer seems to have indicated in that matter is that he wants the big 4 incumbents to remain intact. While his dilemma is understandable, it does have the undesirable consequence of taking away the discipline posed by the threat of takeover from a competitor. Banks are already protected by the Bank Shareholders Act and for the big 4 to be immune from takeover really puts them into a privileged class again with some similarity to the pre-deregulation period.

I believe that the foreign bank era is now over, the main hope for competition for the banking oligopoly is competition from the insurance oligopoly. This comes from the fact that banks and insurance companies are able to compete in each other's backyards.

To me this sort of green fields cross competition is the best way to handle the fact that for better or worse, we are stuck with two powerful oligopolies in the financial sector. This competition has worked well, so well that members of each oligopoly seem to have decided to bury the hatchet and combine. Thus the NM/ANZ merger proposal. To me this is hardly conducive to competition and efficiency. I believe it would be far better for both oligopolies to be encouraged to compete against each other via competition; that reflects green fields internal growth rather than anti-competition purchases of market share in each other's patch.

So it seems to me that deregulation and competition have well and truly passed the peaks of their influence. We still have four very powerful, but admittedly much more efficient, incumbent banks plus ominous signs of anti-competitive behaviour between our banking and insurance oligopolies. I believe that these trends pose major policy issues. ■

ROBERT A. FERGUSON is with Bankers Trust Australia Limited. This article appeared in the "Economic Papers" published by the Economic Society of Australia in the September 1990 issue.