Australian Banking – Current Conditions and Prospects

Talk by Deputy Governor, Mr G.J. Thompson to CS First Boston Australasian Banking Conference, Melbourne, 28-29 September 1995.

I propose to say a few words on the state of Australia's banking industry; then comment on a couple of current issues in banking supervision; and, finally, speculate a little about longer-term developments.

Current Conditions

A snapshot of the current banking scene shows a pretty healthy view:

- impaired assets, as a proportion of the total, have fallen to below 2 per cent, from a peak of 6 per cent only three years ago;
- charges against profit for bad and doubtful debts have fallen well under $^1/_2$ per cent of total assets, compared with $1^1/_2$ per cent in 1991/92;
- the ratio of banks' operating expenses to income has been falling, both because incomes have strengthened with the decline in non-accruals, and because of progress in cutting excess costs;
- average domestic interest spreads have declined a little compared with 1994;
- after-tax profits are running at about 15 per cent of shareholders' funds (this is, of course, an average with a dispersion of individual banks' results around it);
- the average capital ratio, on a risk-weighted basis, is just over 12 per cent, its highest point since calculations began in 1988;
- banks have (on balance sheet) 48 per cent of Australia's financial system assets, and control another 12 per cent through subsidiaries (including funds managers); these figures are both up a little on 1994, and the highest for some decades.

Even when things look rosiest, of course, there are still problems and challenges to be surmounted – competition from new players; public debates on fees, charges and margins; some resistance to the rationalising of branch networks; and the need to manage major change sensitively inside banks themselves. No doubt we will be hearing a good deal about these issues during the next two days. I will touch on some of them later, but first some comments on a couple of current issues which are important from a banking supervision viewpoint, both relating to capital.

Bank Supervision Issues

Capital guidelines for market risk

As you know, the Basle Committee on Banking Supervision has been working on capital adequacy guidelines for market risk for some years. The Committee plans to finalise these by the end of 1995, providing then a two-year phase-in before they became fully effective at end 1997.

We have reviewed Basle's latest draft (issued in April 1995) and, after taking account of views from Australian banks, we've sent final comments to the Committee. They are available to anyone who is interested.

With the option of using internal models now made available, in addition to the standard model originally proposed, we are endorsing the general framework of the guidelines.

We have, however, queried the arbitrariness of some of the adjustment factors which may be applied to the results of internal models, and we wonder whether the final capital charges produced by this scaling of model results might not prove over-conservative. (If so, this could work against Basle's laudable objective of encouraging banks to develop models best suited to their particular operations.) We have also suggested that the list of acceptable internal models might be expanded beyond ones based on 'value at risk'.

On points of detail, we reiterated our earlier concerns about:

- the validity of (and need for) a third tier of capital; and
- the differences which will arise in the risk-weighting of certain credit exposures depending on whether they are held in the trading or non-trading book of a bank.

If these particular provisions remain in the final guidelines we will need to decide how far to apply them in Australia. This is a tricky area. On the one hand, we alone 'carry the can' for supervision of Australian banks and need to be comfortable with the capital requirements applying to them. On the other hand, as banking becomes increasingly an international industry, strong 'competitive equity' arguments can be made against significant local departures from capital rules which will be adopted widely around the world.

For all the effort which has gone into this particular reform, we estimate that the market risk proposals will probably add little to *minimum* required capital for the Australian banking system, given present levels and types of trading activities. (For banks with only modest trading operations there would be virtually no impact. Even for some banks with substantial activity there could be little overall effect, because offsetting positions in the trading book are given recognition not permitted under current rules.) Even where required minimum capital goes up, the size of current buffers would substantially reduce the need actually to raise more capital.

Late in 1994 our supervisors commenced a program of on-site visits relating to management of market risks by banks. This is helping us prepare for the task of assessing the adequacy of internal systems for those banks wishing to use them in calculating capital requirements.

Capital, competition and risk

One particularly intriguing feature of the current scene is the combination of:

- robust levels of bank capitalisation;
- the recent history of after-tax rates of return on shareholders' funds in the mid to high 'teens; and
- strong competition for a share of the available lending business – which is growing, but not rapidly.

As noted earlier, the average ratio for all eligible capital in mid year was just over 12 per cent. Perhaps more significantly, the average *Tier 1* ratio was a little over 9 per cent, compared with the required minimum of 4 per cent; the range for Australian-owned banks was from around 7 to around 12 per cent.

I don't know what the 'right' amount of capital in the banking system is. And, as a supervisor, I hesitate even to suggest that there could be too much of it! But, even allowing for an expected increase when the economy and borrowers are doing well, current capitalisation seems rather comfortable.

Banks will almost certainly have difficulty maintaining recent returns for shareholders with capital around this level. While competitive pressures are hardly abating, the sources of 'easy' gains in profitability from reduced bad debt expenses and cuts in operating costs have largely been depleted.

Of course, one way for tensions in the present conjuncture to be lessened would be for shareholders to realise that a continuation of post-tax earning rates around or above 15 per cent is a rather 'big ask', when underlying inflation is around 2-3 per cent. (And banks with no need to tap the market for new capital might begin to question why they have to meet the market's demand for levels of profitability which see their share prices at 1½-2 times net worth.)

Adjustment will also take place through a trimming in capital ratios, which can occur in three basic ways.

The *first* is through acquisitions, either domestically or overseas. It's no secret that the former is getting a lot of attention of late. This seems driven partly by a desire to utilise better existing capital, but also to spread the capital cost of expensive new technology, and as a quick way of building market share where banks see long-run opportunities but are currently under-represented.

I suspect that Australia has more generalist banks than it can support in the long-run, and that pressures for consolidation will persist. This will promote the efficiency of the banking system, and should therefore be in the long-run interests of bank customers. Of course, concerns need to be addressed about the potential for competition to suffer as numbers decline. While it is impossible to put such worries to rest conclusively, I believe they should be substantially allayed if full account is taken of the ways in which new technologies and innovation are making banking more 'contestable' – not only by non-banks, but also by banks which might not have a strong physical presence in a particular geographic market.

A *second* set of ways to trim capital comprises returning it directly to shareholders, increasing dividends and making dividend reinvestment programs less attractive. Some banks have, of course, taken these options recently or are planning to do so. The RBA has to approve any return of capital, with permission depending on a bank's capital position remaining adequate after the repayment, taking into account our assessment of the bank's overall condition.

The *third* option is to expand balance sheets, by bidding aggressively for business. While care is obviously required in the acquisition of any assets, experience from the late 1980s suggests that this course is clearly the most risky when competition for available business is already strong. Our on-site visits to look at credit systems indicate that banks are better placed now to avoid the sorts of problems which arose from the rush-to-lend in the 1980s – systems for credit assessment and review have been strengthened in the intervening years. (Of course, economic circumstances are also different, particularly in not featuring the asset price inflation of the earlier period.) But experience also tells us that well-designed risk management systems can still be compromised if other pressures are strong enough.

Against this background, we will be watching closely for any signs of widespread resurgence in imprudent lending. Of course, the main responsibility for such vigilance rests with boards and senior management in banks themselves.

Some wariness about the possibility of credit standards slipping in circumstances of high capital ratios is also evident in the United States and the United Kingdom. For instance, the President of the Fed of New York recently said:

> 'One of the most important challenges banks and supervisors face is to guard against a significant weakening in credit standards. In the aftermath of the 1990-91 stringency in credit, it was not surprising – and even desirable – to see some easing in credit standards. Of late, however, it appears that increased competition among lenders for middle-market and large corporate business has produced a narrowing of margins and additional

relaxation in lending terms. Because experience has shown that easing of standards can be and often is overdone, it is incumbent on lenders and supervisors to ensure that future credit quality problems are avoided' (Bill McDonough, July 1995).

Longer-Term Trends in Banking

Important forces shaping banking for the longer-term will be:

- *increasing competition for traditional banking business,* from both non-bank financial intermediaries (such as mortgage brokers, insurance companies and superannuation funds), and from direct dealing between borrowers and capital markets (disintermediation); and
- *technological change,* which is altering radically the way banks can deliver financial services to customers, as well as lowering their cost – the gradual 'electrification' of the payments system is perhaps the starkest example, but by no means the only one. While new technologies create opportunities for banks, they also heavily absorb management resources and strengthen the hand of competitors lacking traditional distribution networks.

In response to these challenges, the future of banking will no doubt include:

- continuing introduction of new technology to both the design and delivery of services – with, *inter alia*, clear implications for branch networks;
- further rationalisation of the industry to employ capital most efficiently;
- greater focus by banks on areas where they have a comparative advantage – such as lending to small/medium-sized companies which is information-intensive and not readily susceptible to securitisation or disintermediation; and
- more progress in unravelling cross-subsidies in the pricing of services – which means *both* increased use of direct charging to recover the costs of transaction (and other) services *and* further contraction in banks' interest spreads.

Some of these developments will be controversial. Charging for services which have long been regarded as costless – a hangover from the days of regulation – is a rather topical case. Banks need to manage change in this area more sensitively than in recent months, especially in relation to low-income earners and customers least capable of adapting readily to changes in technology. That said, the broad shape of the necessary adjustments in pricing is clear enough if banks are successfully to meet the challenge of specialist competition, *and* if the nation's resources in banking are to be deployed efficiently. (Of course, the size of charges necessary for direct cost-recovery would be reduced by quicker progress in reforming the inefficient paper-based arrangements still used for the bulk of retail payments.)

Having acknowledged the competitive pressures on the banking system, I should also note that, it seems to me, the potential adverse consequences for banks are often overstated and the capacity of banks to adapt underestimated.

It is indeed probable that the share of financial system assets on banks' balance sheets will decline in coming years but, as already noted, this would be from the highest level in a long time. In addition, banks are not much restricted in the range of new financial services which they may offer in their own right or in subsidiaries, on balance sheet or off. They are, therefore, relatively free to participate in emerging markets. Two illustrations of this:

- The fastest growing sector of the financial system in the past decade has been funds management; banks, through subsidiaries, have been able to share more than proportionately in this expansion and now control around 27 per cent of assets under management, up from 21 per cent in 1990.
- The fact that mortgage originators are now responsible for a sizeable slice of total

housing loan approvals (perhaps 7 per cent in the past year) has attracted a good deal of attention. It is less often remarked that banks still have a good piece of this activity, either as the ultimate financiers of loans or as managers and supporters of securitisation vehicles.

Banks are also, of course, the dominant players in trading and other off-balance-sheet activities. Their strong standing gives them advantages in markets which help to offset the costs they bear through closer prudential supervision than most other financial institutions.

Trends in Bank Supervision

Finally, what developments are likely in bank supervision?

The trend to *global harmonisation* in bank supervision will continue, driven by the Basle Committee and, to a less extent, the European Commission. International standards will impact on Australian banks because it is not practicable for them to be supervised very differently from what is regarded as best practice in the major offshore markets.

Bank supervision will move further in the directions of:

- requiring banks to give more attention to internal *risk management systems*, reflecting, *inter alia*, a recognition that prescriptive supervision on its own is not well-suited to protecting against misadventure in financial markets where innovation and volatility are key elements; the acknowledgment of internal models in the market risk proposals is an example of this focus; and
- harnessing market discipline as an ally, by encouraging improved *disclosure* of information; US proposals on derivatives are a case in point.

The RBA, as bank supervisor, will also be working more closely with *other regulators* in the interests of ironing out inconsistencies and overlaps in supervisory requirements and reducing opportunities for regulatory arbitrage. The Council of Financial Supervisors is providing an effective forum for this.

The linking of banks and other financial institutions in conglomerates is causing the different regulators to liaise more closely. And as non-bank financial institutions increasingly offer bank-like products – and banks, conversely, move to offer insurance and superannuation-type products – there will be pressure for convergence of supervisory standards. Of course, harmonisation does not mean that all financial activities are regulated in exactly the same way, but it is increasingly accepted that there is merit in regulating similar risks in similar ways wherever they occur. An example of this is AFIC's adoption of prudential standards for building societies and credit unions, which are modelled closely on those for banks. Internationally, we see the Basle Committee and the regulators of securities companies trying to agree on common capital rules for market risk.

It is probable that these trends will excite debate on the pros and cons of going beyond harmonisation to thinking about mega-regulators. I believe the much-discussed 'blurring of distinctions' in financial markets has a long way to go yet before that would be a sensible option. But that is a topic for another day, and another conference.