FINANCING OF SHAREBROKERS

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Mr Chairman, ladies and gentlemen. Thank you for having me at this conference. The two previous speakers have made it all sound very difficult. Let me assure that the financing of stockbrokers is very simple. As much as possible, as soon as possible, and above all, as flexible as possible!

You have in your folders I hope a publication that was released by the Australian Stock Exchange this week. It is our first attempt at an official publication by the ASX. I hope you find it of interest and I certainly hope that some of you might find it appropriate to subscribe.

Deregulation over the course of the 80s has had very substantial effects on the financial operations of Australian stockbrokers. The Australian market is no longer an enclave to itself. The environment is increasingly characterised by much greater international competition. No longer does a Brisbane broker compete only against another Brisbane broker. Rather, he competes with all Australian and many international brokers, for business transacted both in the Australian market and in other major world stock markets. The elimination of foreign exchange controls has meant that the two-way capital flows between Australia and overseas are now much larger in value and can occur at the speed of a telephone call or in the time it takes to press a button on a computer terminal.

If Australian brokers are to compete on an equal footing with brokers in other major world centres, they must have the finance to invest in the latest technological and communications equipment to service clients efficiently and on a global basis.

A significant and permanent capital base is therefore essential for both growth and survival. I propose to briefly outline how these financial needs have been crystallised and grown, and how satisfactorily meeting these financial needs have been of benefit not only to the investing public, but also to the economy and the community at large. This is the first time you have got anything free from Freehills.

From the 1st of April 1984, stockbrokers were able to incorporate for the first time. Since that date over 70 percent of Australia's brokers have seized the opportunity to do so, to overcome the problems inherent in operating in a partnership structure. Of the 80 incorporated stockbrokers currently operating in Australia approximately half have overseas partners. Of these overseas shareholders, about one quarter have links with overseas stockbrokers, another quarter have links with overseas banks, and another quarter have links with overseas merchant banks.

In a number of cases the overseas interests have now acquired 100 percent of the equity of the local stockbrokers. Nevertheless, the majority of brokers are still at least half owned by Australian shareholders. There are five Australian banks and about eleven merchant banks which have interests in stockbrokers. In Perth, Hobart, Adelaide and Brisbane, (we colloquially refer to them as the PHABs), ten incorporated brokers have links with either Melbourne or Sydney stockbrokers.

Over the last ten years the capital of brokers has risen from a level of $20,000,000 to a current figure of about $730,000,000 including subordinated debt. The increase in the year to December 1987 alone was over 100 percent. There are both direct and indirect benefits of this increased capital base. The direct benefits relate to increased ability to overcome the significant problems arising from volatile markets. The indirect benefits arise through enhanced investor protection and more ready availability of funds for industry development.

I would like to deal briefly with the effect of the October collapse on brokers' financial situations. It was in fact October the 19th, October the 20th, not October the 13th Phillip - and I can assure you that that is right, it is indelibly imprinted on my mind. It was on that day that a new disease entered the broking industry. We had over a number boom years a new breed of person in the industry, the young, upwardly mobile, highly paid, senior executive, aged probably 25. On that day he very quickly contracted a new disease. It is known as "raids", simply "recently acquired income deficiency syndrome".

The October crash saw 25 percent or about 80 billion dollars wiped off the capitalisation of listed companies on that day. It extended to about 100 billion by the end of April this year. This substantial reduction in the valuation of listed companies had significant repercussions on the ability of brokers to comply with the liquid capital requirements provided for in ASX Rule 1.1, which has already been outlined by John Story.

The direct benefits of this strong capital base has been emphasised in recent months. Brokers have shown a great ability to withstand the large and sudden movement in the market.

Moreover, liquidity was made available by the banking system to a degree not seen before - no doubt because banks now have much greater confidence in the financial strength of the broking community.

It is a most favourable reflection on the health and sophistication of the industry that the Australian Stock Exchange was able to report at the end of the week of the October collapse that the Australian industry had come through without any major problems. That this outcome was achieved is also most importantly attributable to the very stringent financial accounting and monitoring processes in place. Brokers must continually be aware of their exposures and regular reporting of various aspects of their financial situation is required by the ASX.

Six months after the event I can say that the ASX Board sees no reason to change, roughen up or restrict, any of the existing surveillance measures. The October collapse proved to us that properly administered, they work well and they give the industry and the investment community the protection that is required.

Financially powerful outside shareholders have also provided substantial second line strength through the speedy injection of additional capital or subordinated debt. In the week of the crash $53,000,000 was injected by way of subordinated debt into two ASX member corporations and there has been a total of $129,000,000 of subordinated debt added to the capital base of Melbourne and Sydney brokers since the 19th of October.

All injections of subordinated debt have been made to incorporated brokers, reflecting the fact that stockbroking corporations are usually much larger in size, do a greater volume of business than partnerships, and can achieve a faster injection of funds when the need arises.

At the end of December 1987, the value of approved subordinated debt was equivalent to 77 percent of total proprietors' funds, compared with 21 percent in June 1986.

During 1987 the amount of subordinated debt rose by nearly 500 percent, compared with an increase in total proprietors' funds of only 30 percent. The injection of funds into brokers by financially powerful shareholders is a less costly and speedier method of obtaining funds than is reliance on family, friends and bank overdraft facilities on which partnerships have traditionally relied.

Apart from the advantages which access to subordinated debt provides to brokers when the market is under pressure, an expanded capital base will, generally speaking, help meet the financial needs of brokers in a growing market. Specifically, it provided the infrastructure to help cope with the enormous increase in business done over recent years.

The value of equity turnover increased by over 1000 percent between 1981/82 and 1986/87. To make the point a little more graphically, there were a number of days in 1987, single days, when the turnover on the ASX was in excess of the turnover for the total year of 1974. Despite the October crash, current equity turnover is running at an annualised 45 billion dollars. This is lower than 1986/87 but still at a rate 40 percent higher than the previous financial year.

Similarly, the market capitalisation of companies listed on the Exchange rose by 66 percent during 1986/87 and was nearly 500 percent higher than in 1981/82.

Such increases in activity levels on the ASX have put significant pressure on Australian stockbrokers to satisfy client demands while at the same time maintaining their liquid capital requirements. I believe there is no doubt that had Australian stockbrokers not adopted corporate structures and taken in outside shareholders, many would not have been able to .PA efficiently cope with the great increase in business which has occurred.

Without financially strong brokers the tendency for foreigners to invest in Australian securities, but to do their business offshore, and the tendency for Australian investors to increase the value of their investments in overseas corporate equities, may have increased even more sharply than that which already has occurred.

I think it would now be useful if we look briefly at the indirect effects of this increased capital base on Australian stockbrokers.

First, it has through linkages bolstered investor protection provided by the National Guarantee Fund. The linkages work this way:

(1) The expanded capital base has facilitated the accommodation of the substantially increased activity levels in the market.

(2) This has in turn increased revenues and profitability of Australian stockbrokers.

(3) It has boosted the levels of trust accounts held by brokers.

(4) The higher amounts in these trust accounts directly lead to a larger value of the National Guarantee Fund as brokers are required by sub-s.97(3) of the Securities Industry Code, to lodge with the ASX an amount equivalent to one-third of the minimum quarterly balance of their trust accounts.

The interest on these deposits is payable to the National Guarantee Fund. As exchange activity rises, so too do balances in trust accounts and so the amount of the National Guarantee Fund. The six months to December 1987 saw the Fund grow by 11.3 million dollars and today it has a total corpus of $68,000,000.

The protection provided by the National Guarantee Fund consists essentially of two parts - (1) a guarantee of contract completion and (2) protection against insolvency by Australian stockbroking organisations. Previously claims could only be made against the former Fidelity Funds by those persons who suffered pecuniary loss on account of defalcation or fraud on the part of Australian stockbrokers. The protection provided by the National Guarantee Fund is more targeted to address the central concerns of investors on the market than did the previous Fidelity Funds.

As far as investors as concerned, the bottom line is that contracts which are made with their brokers for sales or purchases of securities, will be completed. This is the guarantee the Fund ensures.

If I could mention as a side issue, there is no longer a need for you, as lawyers, to advise your broking clients, to bank cheque each other for settlement. This started immediately after the crash when there were some doubts about a couple of technical aspects of the regulations of the National Guarantee Fund, and it was probably the greatest threat that the market had to market confidence during that period. Fortunately, we were able very quickly to make the regulatory changes to satisfy some technical views that were expressed by one or two lawyers and bank chequing has stopped.

I think we should, from that point, move on to industry development. Second, the expanded capital base has again, through linkage effects, led to efficiency enhancements for the ASX. An important feature of the operation of the National Guarantee Fund is that the National Securities Exchange Guarantee Corporation may determine that a specified amount of the National Guarantee Fund be paid out of the Fund to the ASX for deposit in the Securities Industry Development Account. The ASX may then, subject to Ministerial or Council approval, (I guess that is shortly going to become ASC approval) make payments out of this development account for purposes relating to industry development. To date about $10,000,000 has been paid out of the development fund for approved industry development purposes including the initial work on the development of automated screen trading and the proposed streamlined clearing house system.

Thirdly, the expanded capital base has allowed brokers to give more efficient services to clients, particularly larger overseas clients. Figures show that the percentage of total revenue which is derived from agency transactions, in other words brokerage, now constitutes about two-thirds of total brokerage revenue compared with a figure of about 80 percent in the latter part of the 1970s and early 1980s.

While the reduction in revenue derived from agency business can partly be attributed to the deregulation of brokerage rates on 1 April 1984, the particularly sharp decline which has occurred since deregulation, could be ascribed to the increasing role of stockbrokers in principal transactions and in business other than traditional agency transactions. Revenue from brokers trading on their own behalf as a percentage of total stockbroking revenue has more than doubled, compared with the late 1970s and early 1980s.

If the Australian industry is to compete more effectively on an international basis, the need to take principal positions will become even more important, particularly where foreign clients are concerned. Time and distance differences are such that these clients will only do business in Australia if they can be assured that their transactions can be executed speedily and efficiently. As the Australian market tends to be less liquid than major overseas markets, pressure is correspondingly increased on Australian brokers to satisfy the demands of foreign clients by taking principal positions in order to facilitate transactions. Why do this? If we do not do it, the business will be done in London and New York whilst we are asleep.

The Australian market is less liquid than major overseas markets of New York and Tokyo. Over the year to the end of December 1987 the liquidity of the Australian market was 53.3 percent, slightly in excess of that for London - 53.2 percent, but about a third less than Tokyo's 75.5 percent, and even less than New York's 84.5 percent. However, we are catching up. The liquidity of the Australian market has increased much faster than any overseas market over the course of the 1980s. It quadrupled over this period whilst London trebled, Tokyo doubled and New York increased by two and a half times.

Fourth, lenders in general are much more inclined to provide funds to those organisations which are substantial in terms of absolute capital base. As member corporations have substantially larger capital bases than partnerships, the attractions to lenders in providing funds is obvious. Fifth, the larger capital base of brokers has facilitated the huge rise in underwritings which has occurred over the past few years. Revenue derived from brokers' underwriting fees has almost trebled from the late 1970s and early 1980s. During this time risks associated with underwritings are substantial and corporations would not entrust these transactions to brokers unless they were satisfied with their financial ability to deliver. Indeed figures show that the capital raisings underwritten by Australian stockbroking organisations rose to a figure of 11.8 billion dollars in 1986/87, compared with a mere $155,000,000 ten years earlier.

Brokers are also using newer financial instruments to more effectively run their organisations. Cash management trusts, for example, reduce the need for brokers to directly fund client transactions by providing sweep facilities between broking and cash trust accounts. Both client and broker are better off. The broker gets paid on delivery of documents and the client earns interest on his funds until that time.

The use by brokers of the commercial bill market provides a valuable alternative to more expensive overdrafts from banks. There are, of course, risks associated with the commercial bills markets in terms of volatility of interest rates, which in turn relate to the ebb and flow of capital transactions in and out of Australia and movements in fundamental economic indicators in Australia and overseas.

The movement towards deregulation of finance and securities markets around the world has had the effect of giving greater scope for competitive forces to operate. The demarcation lines between various financial instruments or investment products has become obscured. Real estate groups have obtained dealers licences which permit them to deal and advise in securities. Stockbrokers have taken interests in investment advisors and established themselves in secondary mortgage markets, which in turn have converted investment products of the real estate industry into tradeable securities. The trend towards securitisation of what hitherto were considered to be unique forms of investment - for example, property, debt instruments, franchises, agricultural ventures - mean that the finance and securities markets are being very closely integrated. A number of financial institutions which have interests in Australian brokers, already have interests in one or more overseas brokers. These overseas brokers can complete a world-wide linkup of the major securities markets.

As participants in the finance and securities markets move towards closer integration in consonance with the integration of the markets themselves, it is clear that capital movements will increasingly take on an international characteristic.

In conclusion I would like to say that deregulation has led to a more integrated Australian capital market and a much broader role for Australian brokers. This broadened role has created challenges and opportunities, particularly in relation to overseas markets. To be able to meet international competition head on it has been imperative that the capital bases of Australian stockbrokers, and their access to finance, be correspondingly increased to meet the new opportunities in the increasingly deregulated marketplace. Since 1984 the opportunity for Australian brokers to diversify into the broader finance and securities industry has been grasped, largely through increased injection of funds, which has occurred as a result of incorporation.

The capital base of Australian stockbrokers has increased exponentially and the benefits of this enhanced capital base are many-fold. They are not merely limited to the ability of brokers to meet capital liquidity requirements.

The advances which have been achieved by Australian brokers in this regard can be seen as both being dictated by, and complementary to, the deregulatory changes which have been made in the Australian economy since 1983. Clearly the deregulatory changes have done much to raise the liquidity or efficiency of the Australian market. As is evident, the liquidity of our market has shown a stunning rise over recent years and is about equal to the much larger London market.

The efficiency enhancing initiatives of the ASX, combined with the enlarged capital base of Australian brokers, means that the Australian securities industry is now in a very sound basis for the future.