FINANCING OF SHAREBROKERS

KEVIN WEIR

Chief Manager - Credit Bureau
National Australia Bank, Melbourne

FINANCING OF BROKERS

Before specifically addressing the subject of lending to stockbrokers, I would like briefly to review certain events which have initiated the deregulation within the industry and others which have set parameters which impinge upon prudential considerations made by a lender in extending facilities to brokers.

First, in 1981, the Campbell Committee of Inquiry issued its final report upon the Australian Financial System. Embodied therein were the following observations made regarding the efficiency and structure of the securities market:

(1) The Committee concluded that on evidence available to it, a qualified case had been made, on efficiency grounds, for the deregulation of broking rates.

(2) The Committee recommended that Stock Exchange Rules should be amended to allow members to incorporate.

In 1981 also the majority of states passed Securities Industry Codes and on 1st April, 1987 we saw the Australian Stock Exchange commence business.

Such events have established the "rules" within the industry and which must be considered by bankers in providing accommodation to brokers. No longer do we have broking firms comprised solely of partnerships, many have incorporated and the industry now includes publicly listed companies, some are wholly owned by publicly listed companies and all major privately owned domestic banks have acquired leading firms. Many provide a range of financial services other than stockbroking.

Lending to a Stockbroker

General Facilities

In lending to a stockbroker the facilities that might be provided today are many and varied. They encompass overdraft, bills

accepted/discounted, guarantees, market rate advances, overnight accommodation, leasing, letters of credit, overseas currency loans and various dealing limits to cover facilities such as foreign exchange, forward rate agreements etc. It goes on and on. In considering these a banker must give recognition to the self regulating controls as mentioned by John Story, exercised over a broker's activities as set out in the rules of the Australian Stock Exchange and of course certain provisions of the Securities Industry Code.

In particular the capital liquidity requirements of Rule 1.1 of the Australian Stock Exchanges Rules provides a level of comfort to a lender for the ongoing financial health of the borrowing broker. Under Rule 1.1 adjusted liquid capital as defined, and John Story has given you an explanation of that, must be maintained at certain levels.

However, the borrowing proposals of a broker may be such that a banker will look to obtaining conditions other than relying upon the requirements of Rule 1.1 and embodying same in a comprehensive loan agreement. Other financial covenants to be imposed may include such things as negative pledge, minimum tangible net worth or shareholders' funds, working capital ratio, perhaps a limitation on in-house positions, and certainly periodic provision of financial information such as annual accounts, perhaps the quarterly ASX returns and in some cases ageing of debtors.

Of course, loan conditions are determined on a case by case basis and would take into account the purpose of the borrowing, the status of the borrower and the security which may be available or offered.

In borrowings of a partnership, recourse to the individual partners remains but within a company structure, the banker may seek a guarantee or letter of comfort from the parent company.

Tangible securities may be available or offered by way of a lien over securities owned by the broker, assignment of book debts or mortgage debenture. There are no hard and fast rules - each lending proposal must be assessed on its merits and individual circumstance.

In looking through a range of broker clients of the bank I will quickly run down some of the provisions that apply to borrowing arrangements:

COMPANY "A" - Facilities approximately $40M

- Net tangible worth to be maintained at not less than $12M.
- Subordinated loans not to be repaid without Bank approval.
- Provision of Audited financials as at 30th June each year.
- Provision of quarterly ASX returns.
- Letter of Comfort from parent.

COMPANY "B" - Facilities aproximately $80M

- Capital and subordinated debt to be not less than $30M.
- Negative Pledge.
- In-house positions restricted as to amount.
- Book debts always to exceed amount of Bank indebtedness.

COMPANY "C" - Facilities approximately $60M

- Negative Pledge.
- Current ratio of 1 to 1.
- Shareholders Funds to be not less than 30% of Total Tangible Assets.
- Listing of debtors with ageing on a quarterly basis.

COMPANY "D" - Facilities approximately $80M

- Negative Pledge.
- Any liability to Bank to always be covered by debtors (net) and readily saleable securities owned by the company.
- Annual accounts to be provided on a timely basis.

It can therefore be seen that what we do is try and "cut the suit to fit the cloth".

Special Arrangements

I would like now to turn to a special borrowing arrangement that may be made by bankers in financing brokers' requirements - the special borrowing facility to complete the daily purchase and sale of securities with advances so made available being repaid within the same day. This particular facility may be called "within the day accommodation" or perhaps even referred to as "daylight cover". The banker would probably seek to place conditions on such borrowing in order to monitor the making of such advances and the repayment of those advances within the day. The conditions may include:

1. Requests for advances to be lodged as early as possible.

2. Details of the required advance.

3. Advances made by bank cheque.

4. Securities to be purchased to be sound and readily saleable and not subject to large price fluctuations.

5. Settlements capable of completion within the day.

6. Counterparty risk to be acceptable to the Bank. Large transactions in relation to the financial strength or capacity of broker may be subjected to special enquiry.

7. Repayment of advances to be made by bank cheque or other clear funds.

8. If settlement fails and the advances made are not cleared as intended, the broker may undertake that securities subject to that settlement will be lodged with the Bank as security until such time as the settlement is completed. If the lodgement of such security is a lodgement to which s.72(2) of the Securities Industry Code applies, the broker warrants that the required notice to client has been made and acknowledges the Bank's lien over such security.

   Alternative arrangements may be that any uncleared balance can be refinanced at the end of the day from other available lines of credit.

Lodgement of Scrip as Security to Cover Advances

I would like now just to touch on lodgement of scrip as security to cover advances, and it seems to me that nowadays there are two categories of scrip security which can be so dealt with. One, of course, is the investments that are owned by the broker in his own right. The other is a lodgement under s.72(2) of the Securities Industry Code and this particular section prohibits lodgement of securities that are the property of another person unless money is owed to the broker by that person. The broker must give written notice to the person, identifying the documents to be lodged as security for the loan, and the amount of the loan against such security must not exceed the amount owed to the broker by his client.

Lodgements under s.72(2) of the Securities Industry Code of course are more applicable to within-the-day type facilities and I mentioned that in any arrangements involving the lodging of securities to cover a loan, the lender must satisfy himself as to that ownership of those investments or the borrower's right to pledge.

Case law is scattered with situations where the competing claims of banks, brokers and/or clients have been adjudicated on and it is fair to say that in the majority of cases, the broker's clients have been more successful.

The rules governing such lodgements nowadays to me seem to be fairly clear and banker's requirements to satisfactorily resolve ownership and the right to pledge may put them in a position of some difficulty when dealing with their broker clients of good and long standing relationship.

I would like to recall for you a situation when I was a young manager and I was appointed to a branch where they boasted having the business of a broking firm which utilised within-the-day accommodation. Of course, as the firm's business expanded, so did the borrowing requirements and there were constant and increasing excesses being a source of some concern to my superiors.

This prompted me to review just what the borrowing arrangement was and on closer inspection one found that the security arrangement, which was totally a lodgement of scrip situation, was less than ideal, but had been put in place for some time and accepted quite freely by previous management.

Early each morning the Bank would issue to the broker bank cheques to enable that broker to effect his purchases for the day, creating substantial within-the-day loans to the broker. Invariably, some contract sales settlements would not be achieved by the closing time that day and any shortfall to clear the within-the-day account was made by a cheque drawn on the broker's general account. Invariably this in turn created substantial overdraft accommodation on that general account for which no approval had been given; it was a situation of robbing Peter to pay Paul.

Security for the overdraft was a locked tin box which was regimentally lodged with us by the broker each night and which of course we religiously locked away in the safe. The bank dutifully acknowledged receipt of that box. The circle started again first thing the next morning. Apart from being issued with a further set of bank cheques to accommodate the new day's purchases, the broker picked up his locked tin box for which we obtained a receipt.

At this stage the bank had granted another serve of within-the-day accommodation, the overdraft from the previous day still sat on our books, and we had released our security! But to top it all off, the locked tin box was always lodged with a covering letter stating the description and value of the shares which supposedly reposed therein, (we could always give the box a shake to test the value!) but the covering letter always stated that the box was being lodged for safekeeping. Really we had no security at all!

This situation presented quite a dilemma, to unwind a long standing arrangement with a valued client which necessitated lengthy, but not costly legal opinion on our position. I am happy to say that after much discussion with the broker we were able to come to some satisfactory other arrangements where those difficulties were completely overcome and that the broker still remains a client of the bank today.

The Stockmarket Crash - October '87

In conclusion, I would like to recall the situations which existed for a banker after the stock market crash in October last.

In the months leading up to October with the "bull" market that was running, record dollar values of turnover were recorded through exchanges. As an example, in the month of January 1987, turnover through the Melbourne Exchange was 2.47 billion,

comprised in 106,000 transactions. For September 1987, nine months later, turnover through the Melbourne Exchange had increased to 4.25 billion in 151,000 transactions; increases of 72 percent and 42 percent respectively.

As further evidence of the conditions which existed world wide, a study of share market indicators would show approximately the following:

> From a base of 100 in January, 1986 these indicators moved as follows in the period to October, 1987:
>
> London to 170
> New York to 175
> Tokyo to 201
> Australia to 211.

Brokers Facilities

During this period, facilities banks might have provided to brokers came under considerable pressure, with excesses of limits being common place.

As early as May 1987, my bank brought the market conditions prevailing to the notice of account managers asking that they particularly address broker account connections to assure themselves of such things as follows:

- Adequacy of back office procedures to cope with volumes of transactions.
- Prudential controls exercised by brokers over their debtors particularly as to quality and age.
- Large excesses of within-the-day accommodation were to be subject to special enquiry and scrutiny.
- Monitoring of in-house positions and underwriting commitments.

Such action enabled our account managers to gain a much closer knowledge of our broker clients' financial condition on an on-going basis during the months leading up to October 1987, and enabled them to respond quickly in these circumstances to meet the broker's reasonable increased borrowing requirements.

With the collapse of the market in October last the principles of overview which I previously mentioned to you continued with particular reference to adherence to facility conditions, in-house positions and underwriting commitments.

I feel that the early action on the bank's part to require our account managers to gain a closer knowledge of our broker clients' condition and business make-up during this period, and this was particularly supported by the brokers concerned, really made the management of the situation from our point of view, far easier than it might have been both from the bank's viewpoint and

also that of the broker. And of course this is the type of co-operation which lies at the very heart of a successful banker/customer relationship.

Other Customers

The stock market crash of course did affect other accounts - accounts where share investments constituted security cover for advances. Such arrangements may have required that security by way of shares to a market value of say 150 percent of the advance would always be held as security. With the fall in the market of course some difficulties are being experienced in having such security cover maintained, borrowers have lost the ability to "top up" the security cover.

In addition, companies whose assets comprised investment portfolios, suffered write-down in asset values which may have placed them in a breach of borrowing covenants. Immediately following the market collapse, all such cases, insofar as my bank is concerned, any inability to top up security requirements, any write-down in asset values occasioning breaches of borrowing covenants, have been subject to special reporting on an on-going basis.

The impact of the market collapse in such situations though was subdued by our early recognition of conditions, as previously mentioned, and in particular using in our credit assessment procedures, an emphasis on a requirement for sound core business, their cash flows and attention to the qualities of assets against which we were lending.