



Auditor-General of Victoria

Special Report No. 13

State Bank Group Impact on the financial position of the State

May 1990

VICTORIA

Auditor-General
of Victoria



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30 May 1990

The Honourable the Speaker
Legislative Assembly
Parliament House
Melbourne Vic. 3002

Sir

Under the provisions of the *Audit Act* 1958, I transmit a report on the State Bank Group - impact on the financial position of the State as at 28 May 1990.

This review was conducted in response to a request of the Legislative Council on 11 April 1990.

Yours faithfully


C.A. BARAGWANATH
Auditor-General

STATE BANK GROUP

IMPACT ON THE FINANCIAL POSITION OF THE STATE AS AT 28 MAY 1990

INTRODUCTION

1.1 The State Bank of Victoria is fully-owned by the State of Victoria which, at 30 June 1989, held equity capital of \$164 million, of which \$45 million was provided from the Public Account and \$119 million was obtained from distribution of asset revaluation reserves.

1.2 The functions and powers of the Bank are specified in the *State Bank Act 1988*. Among other things the Act provides, for :

- ◆ the Treasurer to appoint Board members, one representing the interests of the Treasurer;
- ◆ the Bank to report to the Treasurer in relation to its policy and prudential standards; and
- ◆ the Bank to provide copies of all Board minutes to the Treasurer.

1.3 All of the Bank's liabilities are guaranteed by the State. The *Treasurer's Statement for 1988-89* disclosed that at 30 June 1989 the Bank's liabilities covered by the guarantee amounted to \$53 542 million.

1.4 In February 1990, the State Bank Board in its report on *Results and Financial Position for half year 31 December 1989*, advised that, at that date, the State Bank Group had doubtful debts of \$1 309 million of which \$1 082 million related to its wholly-owned subsidiaries forming the Tricontinental Holdings Group.

1.5 In this report, the Board stated that:

"The asset portfolio of Tricontinental Holdings Group, the merchant bank subsidiary for which the Bank assumed full legal and management responsibilities on 21 May 1989, continued to be adversely affected by non-performing loans. Deteriorating business conditions, marked by record numbers of business failures, have created the need for very heavy provisions by major banks and other financial institutions in Australia (as well as many overseas countries). The concentration of Tricontinental's asset portfolio in areas of higher risk, exposed it to the need for further substantial specific provisioning for doubtful debts, which could crystallise as future bad debts".

1.6 On 22 February 1990 the former Chairman of the State Bank requested that the Treasurer, for and on behalf of the State, enter into an agreement with Tricontinental Corporation Limited to provide to the Tricontinental Holdings Group funding to a maximum of \$795 million in respect of debts due to the Group if and when such debts are written-off as bad.

1.7 The Chairman also confirmed that:

"... the Bank will do all things that you reasonably request of it in order to enable you to fund the obligations which you are to undertake under the Deed of Agreement and which preserve unchanged the shareholders' funds and capital resources of the Bank.

"The Bank recognises that you might request that these obligations be funded by means of the State, or an authority of the State, assuming certain liabilities of the Bank and, as consideration therefore, the Bank agreeing to make payments under the Deed of Agreement in discharge of your obligations thereunder. The Bank also recognises that you might request that a trust or other entity be interposed in the payment flows".

REQUEST FROM LEGISLATIVE COUNCIL

1.8 Resulting from debate within the Legislative Council on the financial position of the State Bank, the Council on 11 April 1990 passed the following resolution:

"That this House requests the Auditor-General to inquire into the financial affairs of the State Bank Group insofar as they relate to or impact upon the administration and financial position of the State of Victoria and report his findings to Parliament".

OBJECTIVES OF REVIEW

1.9 Pursuant to the powers conferred on me by the *Audit Act 1958* for the audit of the Consolidated Fund and in response to the abovementioned resolution of the Legislative Council, I have conducted a review to determine to what extent matters disclosed in the report on *Results and Financial Position for half year 31 December 1989*, have, or are likely to impact upon the financial position of the State.

LIMITATIONS ON SCOPE OF REVIEW

1.10 As I am not the auditor of the State Bank, Tricontinental or any of their subsidiaries, the scope of my review was limited to an examination of relevant records held by the Department of the Treasury, and discussions with officers of that Department. By letter dated 12 April 1990, I advised the Legislative Council of this limitation.

1.11 During the course of the review, my officers made a request to the Department for access to State Bank Board minutes provided to the Treasurer in accordance with the *State Bank Act 1988*. In making the request, my officers indicated that the confidentiality of any commercial information contained in the minutes would be maintained. On 25 May 1990 the Acting Director-General advised that:

"In the context of your forthcoming report on the State Bank of Victoria, your officers have asked that the Minutes of the State Bank Board meetings be released to them.

"The Solicitor-General has advised that the fact of the Minutes being with the Treasurer does not of itself warrant their release and that release is not justified for the purposes of compiling the Report on the impact of the State Bank on the Consolidated Fund.

"If you wish to pursue access to the Minutes, would you please forward to me a request in writing, supported by a statement about the statutory basis which you believe justifies their release. I will give this my immediate attention, taking further advice from the Solicitor-General if I deem this to be necessary".

1.12 In view of the Solicitor-General's advice, audit decided not to pursue the matter of access to the Bank's minutes held by the Treasurer. However, I deem it appropriate to bring this matter to the attention of Parliament.

AUDIT FINDINGS

Solicitor-General's advice on power of Treasurer to enter into agreements

1.13 Before entering into the agreement relating to the State Bank Group's losses, the Department sought the following advice from the Solicitor-General:

"Prior to the Treasurer executing the agreement, he has asked that I seek your advice on 2 matters. The first matter is the Treasurer's power to enter into the agreement. There is no Act which empowers the Treasurer to enter into the agreement and the Department is relying on the general power of the Treasurer to enter into contracts for the purposes of government. It is the Department's view that entering into an agreement which has the effect of preserving the capital of the Bank is for the purposes of government.

"The second matter on which your advice is sought is the arrangement, whereby, the Bank makes payments directly to Tricontinental or the trust and not the Government in consideration of the Capital Works Authority assuming the debt of the Bank. The arrangement has been designed so as to ensure that the payments are not due to the Crown and therefore do not need to be paid into the Consolidated Fund".

1.14 The Solicitor-General advised that:

"In my opinion the Treasurer has power on behalf of the State of Victoria to enter into those 2 agreements. He will need an appropriation for that purpose to allow him to make payments of interest and principal in respect of the State Bank's securities".

Agreement between the State of Victoria and Tricontinental Corporation Limited

1.15 Following the advice of the Solicitor-General, the Treasurer entered into an agreement with Tricontinental Corporation Limited on 22 February 1990.

1.16 The Agreement provides that:

- ◆ Tricontinental may serve on the Treasurer, in its own right or on behalf of a subsidiary company of the Tricontinental Group, a Notice of Claim relating to debts written-off;
- ◆ Notices of Claim must be served within 5 years of the date of the agreement or at such later date as agreed by the Treasurer;
- ◆ Tricontinental shall not serve more than one Notice of Claim in any calendar half-year unless the Treasurer otherwise agrees;
- ◆ within 60 days of receipt of a Notice of Claim, the Treasurer shall pay, or procure the payment, to Tricontinental or to a Tricontinental Group member, an amount equal to the debts written-off which are the subject of the Notice of Claim; and
- ◆ the Treasurer is relieved of his obligations under the agreement when the aggregated Notices of Claim exceed \$795 million.

Agreement between State of Victoria and the State Bank of Victoria relating to the payment of funds to Tricontinental

1.17 As stated earlier, the Treasurer proposes to enter into an arrangement whereby the Bank will make payments directly to Tricontinental in return for the State assuming debt of the Bank equal to the payments made to Tricontinental.

1.18 At the date of preparation of this report the agreement had not been finalised.

Capital adequacy

1.19 The Reserve Bank of Australia has prescribed capital adequacy guidelines for private sector banks aimed at ensuring that the capital resources of a bank are adequate to its size, quality and spread of its business.

1.20 The State Bank voluntarily complies with these guidelines and indicated, in the half-yearly report, that it was in full compliance with the guidelines at 31 December 1989.

1.21 The report also indicated that during December 1989, a \$300 million domestic subordinated debt placement was made by the Bank and that this amount formed, in accordance with Reserve Bank guidelines, capital of the Bank. **Without access to the Bank's records it was not possible to establish whether the placement was required as a result of the State Bank Group's losses.**

1.22 The \$300 million was raised by the issue of 3 series of inscribed stock: one of \$200 million and 2 of \$50 million each.

1.23 The stock has a redemption date of 2004 with optional extensions of maturity date. The interest rate is aligned to bank bill rates.

1.24 The inscribed stock conditions contain an "Events of Default" clause relating to failure of the Bank to meet payments; the Bank becoming insolvent; or the Bank ceasing to be guaranteed by the State of Victoria.

1.25 By agreements dated 29 December 1989 between the Bank and the State of Victoria, the Treasurer has undertaken that in the event of default, the State will contribute further capital to an amount not exceeding \$300 million.

1.26 Audit was advised by Treasury that the \$300 million had not been provided by Victorian State Government bodies. **Without access to the Bank's records I am unable to substantiate this advice.**

Monitoring of the Bank's activities by the Department of the Treasury

1.27 Although the State guarantees the Bank's liabilities, officers of the Department advised that the Government did not involve itself in monitoring the strategic direction of the Bank or the Group. In a statement issued by the former Treasurer of Victoria on 23 February 1990, it was stated that:

"... the Government has placed some reliance on an informal agreement between the State Bank and the Reserve Bank of Australia for the Reserve Bank to supervise the Bank and for the State Bank to meet the prudential guidelines of the Reserve Bank".

1.28 On 2 March 1990 the former Treasurer wrote to the Chairman of the State Bank and advised that it was his intention that the Board adopt the following policies:

- ◆ all borrowings and lending operations in the State Bank Group should be undertaken only by the Bank; and
- ◆ all Bank group credit exposures should be subject to the Board credit procedures.

1.29 The former Treasurer further directed that:

". . . the Board adopt conservative lending practices in corporate and retail banking and not [to] engage in higher risk merchant banking or 'entrepreneurial' lending falling outside agreed prudential standards".

1.30 The Treasurer on 2 May 1990 wrote to the Chairman of the State Bank and advised that in light of the problems of Tricontinental there was a need to strengthen the supervision and reporting arrangements.

1.31 On 4 May 1990 the Bank wrote to the Treasurer and outlined policies that it considered appropriate for the Bank to adopt.

1.32 At the date of preparation of this report the Treasurer has not indicated his acceptance or otherwise to the Bank's proposals.

1.33 In view of the State's potential financial commitments to the Bank in respect of liabilities guaranteed, it is audit's opinion that it is imperative that an adequate supervisory and monitoring role be exercised by the State over the operations of the Group. It is pleasing to note that the Treasurer has commenced action to improve the reporting and supervision arrangements of the Bank.

CONCLUSION

1.34 At the date of preparation of this report, no payments have been made from the Consolidated Fund in respect of losses or potential losses of the State Bank Group. As indicated earlier, drawdowns from the Consolidated Fund under the arrangements with the State Bank Group are dependent on future events, i.e. the serving of Notices of Claim on the Treasurer in respect of doubtful debts which subsequently have been found to be irrecoverable.

1.35 The potential impact on the Consolidated Fund, at this stage, will be the assumption of debt of the Bank up to an amount of \$795 million together with interest. The impact of interest will only be known at such times as the State actually assumes the debt of the Bank.

1.36 The *State Bank Act* 1988 requires that the Bank pay to the Consolidated Fund an amount equivalent to income tax which would have been payable if the Bank had been a public company and an amount of dividend on shares held by the State of Victoria as determined by the Treasurer after consultation with the Bank's Board.

1.37 If the subordinated debt placement of \$300 million referred to in paragraph 1.21 was necessitated by the State Bank Group losses, then the cost of servicing this debt would have an impact on the financial position of the State as it would adversely affect the profitability of the Bank, thereby reducing the returns to the Consolidated Fund.