

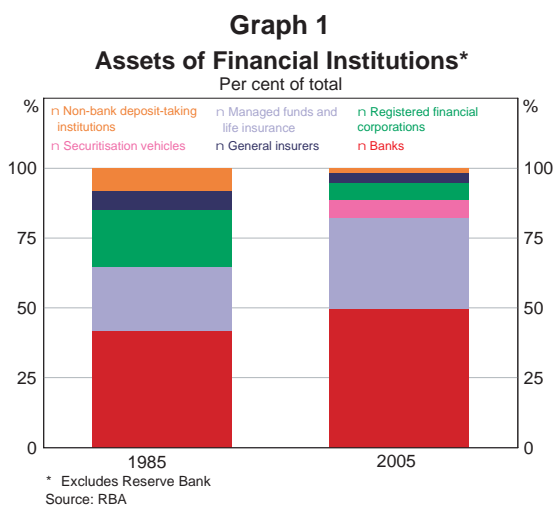
The Structure of the Australian Financial System¹

Introduction

The Australian financial system has undergone significant change over the two decades since the Campbell Inquiry triggered a period of financial deregulation.² Not only have there been marked changes in the relative importance of the different institutions operating in the financial system, but the nature of financial intermediation itself has evolved, along with the deepening of financial markets. This article discusses these developments, with a focus on the changing institutional structure, as well as some of the factors that have shaped this evolution.

Although the distinction between the various types of financial institutions has become increasingly blurred over time, the structure of the financial system is often characterised in terms of the main institutions that operate within it (see Appendix). On this basis, four main developments in the structure of the financial system stand out. The first is the increase in the importance of banks, which today directly account for half of the total assets of the financial system, up from 40 per cent in 1985 (Graph 1).

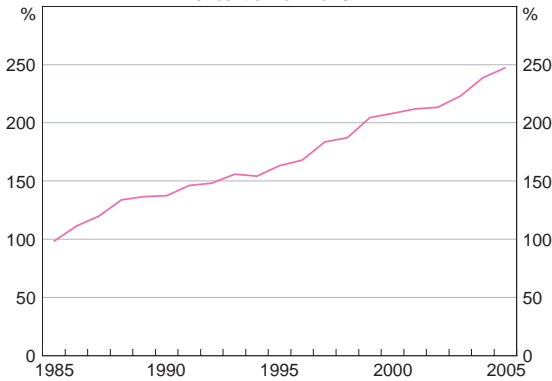
At a group-wide level, banks have become even more prominent, partly by diversifying into funds management and, to a lesser extent, insurance. The second development is the growing importance of securitisation. The third is a marked increase in the share of assets managed through superannuation and other managed funds, partly reflecting changes in retirement income arrangements. And the fourth is the decline in the relative importance of credit unions, building societies, finance companies and merchant banks – institutions that grew strongly in earlier decades partly as a result of the regulation of the banking sector.



1 This article was prepared by Financial Stability Department.

2 The Campbell Committee's recommendations were handed down in 1981, with gradual implementation of the most significant changes occurring throughout the 1980s.

Graph 2
Financial System Assets*
 Per cent of nominal GDP



* Measured as the consolidated claim of domestic financial institutions (excluding the Reserve Bank) against the domestic non-financial sector and the rest of the world.

Sources: ABS; RBA

In aggregate, financial intermediaries currently manage assets of around \$2.3 trillion, equivalent to about 250 per cent of GDP (Graph 2).³ Since 1985, total assets managed by financial intermediaries have risen at an average annual rate of around 12 per cent, considerably faster than the annual average growth in nominal GDP of just under 7 per cent. This financial ‘deepening’ is consistent with the expanding balance sheet of the Australian household sector – which currently has more debt and financial assets, relative to income,

than at any time in the past – as well as the response of intermediaries to the changing demand for financial services. Similar trends are also evident in many other countries as growth in the demand for financial services has outpaced that in nominal GDP.

Banks

Banks play a central role in the Australian financial system, holding the majority of financial system assets. In addition to traditional retail deposit-taking and lending activities, banks are involved in almost all other facets of financial intermediation, including business banking, trading in financial markets, stockbroking, insurance and funds management.

The rapid expansion of banks’ domestic balance sheets – which have grown at an average annual rate of 13 per cent since 1985 – reflects both demand and supply factors, notably in the housing lending market. The decline in inflation in the early 1990s, and the lower interest rates that followed, substantially boosted the demand for housing finance. At the same time, increased competition between banks and other intermediaries in the deregulated environment lowered the cost, and increased the flexibility, of housing finance. Over recent years it has also become increasingly common for banks to source loans through third-party brokers, which have acted as an important conduit for competition. Another factor contributing to the increase in assets in the banking system since deregulation is that a number of building societies have converted to banks.

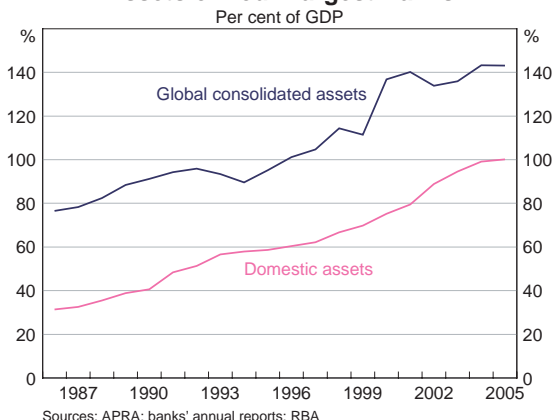
This strong growth in the assets of the banking system has occurred at the same time that the stock of household savings in banks has grown more modestly. As a result, the banking system has become more reliant on wholesale funding, much of which has been sourced from overseas. Since 1990, foreign funding has increased from 11 per cent of total liabilities to around 27 per cent currently (see *Financial Intermediaries* chapter in this *Review*).

³ Here, assets are measured on a consolidated basis, which excludes those assets cross-invested within the financial system. In this sense, the figure represents the net claim of the financial system against the domestic non-financial sector and the rest of the world.

There are currently 53 banks operating in Australia, 14 of which are predominantly Australian owned. In terms of assets on their domestic books, the banks vary in size from \$0.17 billion to around \$270 billion. With the exception of one small bank that is owned by a consortium of superannuation funds, all Australian-owned banks are listed on the Australian Stock Exchange (either directly or indirectly through their parent). There are no banks owned by the Australian government, with the last remaining shares owned by a State government being sold in 2001. All banks are supervised by the Australian Prudential Regulation Authority (APRA).

Within the banking system, the four largest banks – ANZ Banking Group, Commonwealth Bank of Australia, National Australia Bank and Westpac Banking Corporation – have a nation-wide presence and offer an extensive range of financial services. These four banks have around \$960 billion of assets on their domestic books – equivalent to about 100 per cent of GDP – and account for around two thirds of total assets of the Australian banking system (Graph 3). Each of them also has operations overseas, with the largest of these being in

Graph 3
Assets of Four Largest Banks
Per cent of GDP



New Zealand. In total, overseas assets account for around one quarter of these banks' globally consolidated group assets. On this basis, which includes non-banking activities, the four largest banks hold around \$1.4 trillion of total assets, equivalent to over 140 per cent of GDP.

By international standards, these four banks are reasonably large. In terms of consolidated group assets, each of them rank in the top 80 in the world (with the largest of them currently ranked 54th), and in the top 50 by market capitalisation. In part, this reflects the fact that these banks have been very profitable over the past decade, recording an average pre-tax return on equity of around 21 per cent. The bulk of the profits are earned from their core banking business, although profits from non-banking activities, including funds management, have grown more rapidly over recent years. Indeed, following a series of acquisitions and joint ventures beginning around the turn of the decade, banking groups rank among the largest funds managers in Australia, controlling around one quarter of funds under management.

In addition to the four largest banks, there is a group of five Australian-owned banks sometimes referred to as the 'regionals', reflecting their original focus on retail banking in a particular geographical area. Over recent years, however, a number of these banks have attempted to reach new customers in different areas by using loan brokers and the internet, and also by expanding their branch networks across State boundaries. While these banks collectively account for only 8 per cent of total domestic banking system assets, the largest (St George Bank) is the fifth largest Australian bank and in some areas of retail banking has a market share exceeding that of some of the four largest banks.

There are also 39 foreign-owned banks operating in Australia, collectively accounting for 20 per cent of domestic banking system assets. Eleven of these operate as locally incorporated subsidiaries, while the remainder operate as branches.⁴ For much of the 1990s, these foreign-owned banks concentrated largely on wholesale business, following unsuccessful attempts to enter the retail market when barriers to entry were progressively removed in the 1980s. More recently, a number of foreign banks (including ING, Citibank, HSBC and HBOS) have built up sizeable retail businesses, in part through being among the first to offer attractive deposit rates on internet-based savings accounts. In terms of assets, the largest foreign-owned bank (BankWest, which is owned by UK bank HBOS) is the eighth largest domestic bank, accounting for 2.4 per cent of the total assets of the banking sector.

While many of the Australian-owned banking groups have insurance and funds management operations, only two are part of groups that earn a larger share of profits from these activities than from banking. In the case of Suncorp-Metway (the seventh largest bank), nearly two thirds of its profits in the year to June 2005 were from its general insurance and wealth management divisions, while AMP Bank (the 35th largest bank) accounts for less than 5 per cent of AMP's group profits.

Finally, there is one Australian-owned bank (Macquarie Bank) that undertakes predominantly investment banking activities, with this bank ranked as the sixth largest bank in terms of domestic banking assets. In the year to March 2005, funds management contributed almost 40 per cent to its total after-tax profit, while traditional investment banking activities accounted for an additional 32 per cent. Financial markets trading and lending activities accounted for the remainder.

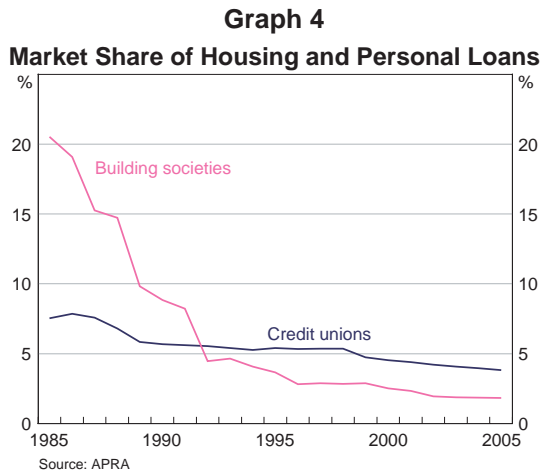
Other Authorised Deposit-taking Institutions

In addition to banks, there are two other types of authorised deposit-taking institutions (ADIs) operating in Australia – credit unions and building societies – which together account for about 2 per cent of domestic financial system assets. These institutions have traditionally focused on the provision of retail banking services to their customers. Like banks, they are supervised by APRA, and are subject to broadly the same regulatory requirements. The main points of difference between these ADIs and banks relate to their capital and ownership structure. All credit unions have a mutual ownership structure where customers are also the 'shareholders'. Many building societies also have a mutual ownership structure, although a number are listed on the Australian Stock Exchange (ASX). While credit unions are not required to meet an absolute minimum level of capital, building societies are required to hold at least \$10 million in capital, compared to \$50 million for banks.

Until the 1980s, credit unions and building societies grew strongly, largely because they were subject to fewer regulations than banks – in 1985, there were 60 building societies and 400 credit unions operating in Australia. Following deregulation, however, the sector contracted and at the end of 2005 there were only 14 building societies and 157 credit unions – the largest of these has assets of around \$4.3 billion (equivalent to the assets of the 27th largest bank) and operates almost

⁴ Branches are not subject to minimum capital requirements and are not permitted to accept initial deposits of less than \$250 000 from Australian residents and non-corporate institutions.

50 branches. The decline in the number of institutions is a result of mergers and acquisitions within the sector, as well as a number of institutions being purchased by, or converting to, banks. In turn, this reflects the external pressures on the industry, which have included: a reduction in the favourable tax treatment of mutual income in the mid 1990s; difficulties in raising external capital; and increased competition from banks and mortgage originators, in part facilitated by loan brokers, in the sector's main business lines – housing and personal loans. Indeed, the combined share of credit unions and building societies in the housing and personal loan markets has fallen from almost 30 per cent in 1985 to less than 6 per cent currently (Graph 4).



Registered Financial Corporations

In addition to banks, building societies and credit unions, all of which are subject to prudential regulation by APRA, there are two other types of financial institutions that intermeditate between lenders and borrowers in the Australian financial system, but are not authorised to accept deposits – finance companies and money market corporations (also known as merchant banks). These institutions are also collectively known as ‘registered financial corporations’. They are not supervised by APRA, but are subject to the same conduct and disclosure regulations that the Australian Securities and Investments Commission (ASIC) applies to the non-financial corporate sector.

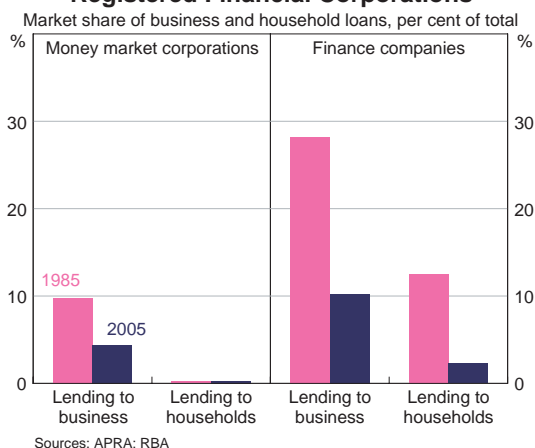
Money market corporations use short-term borrowings to finance loans to the financial and business sectors as well as to fund investments, the bulk of which are in debt securities. Finance companies, by contrast, hold a larger proportion of their assets as loans to the business and household sectors. Loans to businesses are often in the form of lease finance, while household loans are typically for motor vehicle and retail purchases.

The relative importance of these institutions has declined significantly over time. Collectively, they currently account for 6 per cent of the total domestic assets of financial intermediaries, down from around 19 per cent in 1985. Their declining significance has been reflected in reductions in their share of total lending to the business and household sectors (Graph 5). As is the case for non-bank ADIs, this reflects a combination of factors, including the reduction in regulatory constraints on the banking system (which had accounted for much of the original growth in the sector).

There are currently 105 registered finance companies, with all but 10 of these having total assets of less than \$2 billion. Taken together, their total assets amount to \$92 billion, with the largest finance company, Esanda Finance Corporation (owned by ANZ), having assets of

Graph 5

Registered Financial Corporations



around \$13 billion (equivalent to the assets of the 18th largest bank). Most finance companies are involved in the financing of motor vehicle sales or the financing of machinery and equipment. A number of the larger companies are owned by banks, which often fund car loans, leases and unsecured personal lending through their finance subsidiaries, rather than directly from their balance sheets.

The total assets of money market corporations are lower than those of finance companies, at \$75 billion.

There are currently 27 such institutions, with two thirds of these having assets less than \$2 billion. The majority of money market corporations are owned by foreign banks or securities firms. They are typically involved in similar activities to investment banks, including structured finance, acquisition and project finance.

Managed Funds

The managed funds sector has grown particularly strongly over the past 20 years. Aggregate funds under management have increased at an average annual rate of around 14 per cent since 1985, to stand at \$955 billion as at December 2005 (Table 1). This rapid growth partly reflects legislative changes in retirement savings arrangements, as well as investors seeking to achieve higher returns than those traditionally available on deposits with ADIs.

Within the managed funds sector, superannuation funds account for over 70 per cent of total funds under management, with the remainder largely held in public unit trusts. Assets of

Table 1: Funds Under Management

Consolidated basis^(a)

	1990 \$b	2005 \$b	Per cent of total 2005
Superannuation funds ^(b)	128	677	71
Public unit trusts	24	203	21
Cash management trusts	5	38	4
Non-super life insurance	32	23	2
Common funds	7	10	1
Friendly societies	8	5	1
Total	204	955	100

(a) For each sector, figures exclude assets cross-invested in other managed funds sectors.

(b) Figure includes superannuation funds invested through life offices.

Sources: ABS; APRA; RBA

superannuation funds have increased five-fold over the past 15 years, to nearly \$680 billion.⁵ This growth was spurred in large part by the introduction of an employer-funded superannuation benefit in industry awards in 1986, followed by the introduction of compulsory superannuation in 1992. Employers are currently required to contribute at least 9 per cent of an employee's earnings towards superannuation. Data from the 2002 Household, Income and Labour Dynamics in Australia Survey suggest that superannuation is the largest financial asset for more than half of Australian households.

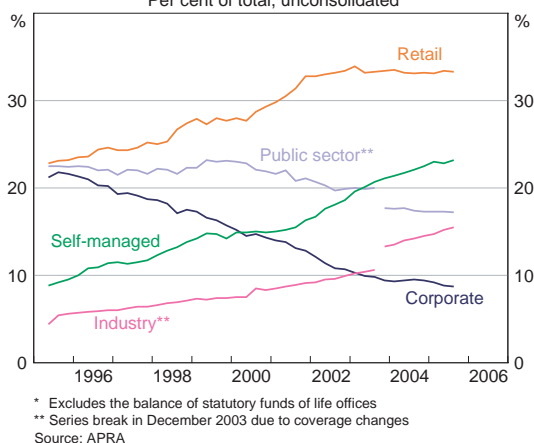
Within the superannuation industry, there has been a marked change in institutional structure over the past decade or so. In particular, the share of superannuation assets managed by retail funds – which offer superannuation products to the public – and self-managed, or 'do it yourself', funds has increased to a combined 57 per cent of total (unconsolidated) assets, up from 32 per cent in 1995 (Graph 6). Retail funds are usually run by large financial institutions and include superannuation master trusts (that is, large public offer superannuation

trusts that pool the contributions of individuals or smaller funds). Industry funds, which traditionally catered for employees in a particular sector of the economy, have also increased their share of total assets, albeit from a lower base. In contrast, the share of assets managed by public sector and corporate funds has declined. At the same time, less than 5 per cent of superannuation assets are now held in defined-benefit schemes, a 16 percentage point fall over the past 10 years. The bulk of assets (around 60 per cent) are held in pure defined-contribution funds, where the investor's return depends entirely on the market performance of their investment. The remainder are held in 'hybrid' schemes, which comprise a combination of defined-benefit and defined-contribution funds.

The assets held by superannuation funds have increasingly been invested in domestic equities and in the units of trusts, which together account for around half of total assets, compared to around 40 per cent a decade ago. A further 17 per cent of assets are invested overseas, while the share invested in interest-bearing securities has declined to 16 per cent, compared to 26 per cent in the mid 1990s.

In addition to superannuation funds, retirement savings are also held in life insurance companies. Indeed, almost 90 per cent of life insurers' total assets are superannuation assets. Notwithstanding this, there has been a marked decrease in the share of total superannuation

Graph 6
Superannuation Assets by Sector*
Per cent of total, unconsolidated



5 According to APRA data, total unconsolidated superannuation assets were around \$790 billion as at September 2005.

assets held by life offices over the past 15 years – currently around one quarter, compared with a peak of 44 per cent in 1992.

The life insurance industry is relatively concentrated. While there are 36 registered companies, the largest three life insurance groups (AMP, MLC and ING/ANZ) account for 60 per cent of total Australian assets (assets backing Australian policyholder liabilities). Foreign involvement in the life insurance sector is also significant, with the largest firms being AXA from France, Aviva from the United Kingdom and Zurich Life from Switzerland.

The next largest category of managed funds is public unit trusts, which account for 21 per cent of funds under management. Some of these trusts – particularly those holding property and infrastructure assets – are listed on the ASX, while others have unit prices calculated by the

manager of the trust. Equities and units in trusts are the single largest asset class held by public unit trusts, accounting for 38 per cent of the total assets of the sector, up from 14 per cent in 1988 (Graph 7).

The remainder of the managed funds sector (for which official statistics are available) is accounted for by cash management trusts (CMTs), common funds and friendly societies. CMTs rose to prominence in the mid 1990s by offering significantly higher interest rates and greater flexibility on cash investments than ADI deposits. As a consequence,

the share of managed funds held in CMTs more than doubled to 5 per cent in the late 1990s, although this share has declined in recent years, partly reflecting increased competition from ADIs' high-yield online savings accounts. Similarly, common funds and friendly societies have lost market share over the past decade or so.

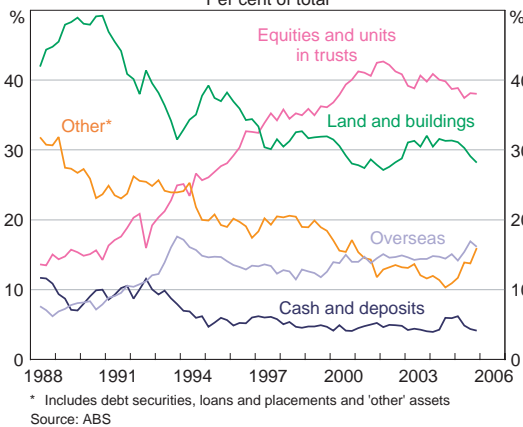
Another form of managed funds which have risen to prominence in recent years are hedge funds. While there is no standard definition of a hedge fund, the name is typically applied to managed funds that invest in a wider range of financial instruments and employ a wider range of investment strategies than traditional managed funds, including the use of derivatives and short-selling techniques. Hedge funds are not regulated by APRA but must comply with laws administered by ASIC.⁶

General Insurance

The general insurance industry has assets of around \$100 billion, accounting for about 4 per cent of domestic financial system assets, down from 8 per cent in 1985. In terms of industry

⁶ See McNally, S, M Chambers and C Thompson (2004), 'The Australian Hedge Fund Industry', Financial Stability Review, September.

Graph 7
Assets of Public Unit Trusts
Per cent of total



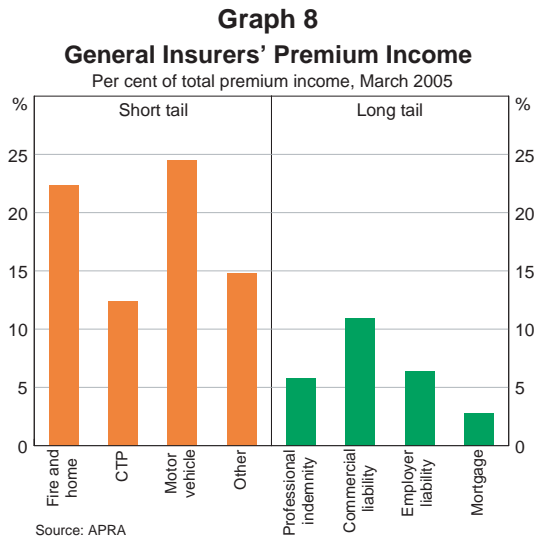
structure, there are 133 active general insurers in Australia, a decrease of 40 institutions over the past 10 years. The largest general insurance group, Insurance Australia Group, has consolidated assets of \$17 billion, with the five largest insurers accounting for about 40 per cent of industry assets. In terms of business activities, around 70 per cent of general insurance premium revenue in Australia is earned from ‘short tail’ business, which provides cover for risks against losses – typically incurred within 12 months of receipt of premiums – on items such as motor vehicles and property (Graph 8). The remainder is due to ‘long tail’ business such as indemnity and liability cover.

In addition to diversified insurers, there are a number of insurers that specialise in particular business lines, including lenders’ mortgage insurance. Lenders’ mortgage insurers (LMIs) provide protection for lenders from losses arising from mortgage defaults. The LMI market is very concentrated, with around 80 per cent of policies being underwritten by the three largest insurers. Of these, two are the subsidiaries of large US LMI groups and the third, a subsidiary of a UK insurer, no longer writes new LMI business in Australia. Around 20 per cent of Australian mortgages are protected with LMI cover, which is relatively high by international standards.

Securitisation Vehicles

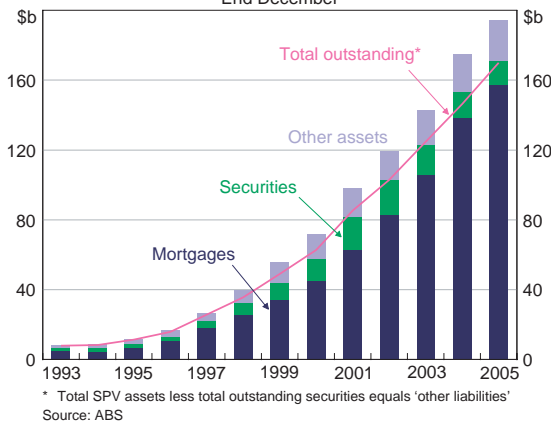
An important influence on the structure of the Australian financial system, particularly over the past decade, has been the growth of securitisation markets.⁷ Securitisation allows financial institutions to fund their lending activities indirectly through capital markets rather than by taking on deposits or borrowing in their own name. They do this by selling assets to a specially created company or trust – usually referred to as a special purpose vehicle (SPV) – which finances the purchase by issuing securities to investors using the assets as collateral. In Australia, as in most other countries with active securitisation markets, residential mortgages have been the predominant underlying asset, but other assets such as commercial mortgages, trade receivables, other loans and asset-backed bonds have also been involved (Graph 9). Securitisation can also take an unfunded or ‘synthetic’ form in which the underlying credit risk on assets, rather than the assets themselves, are transferred to an SPV through the use of credit derivatives.

The market in asset-backed securities has expanded rapidly, growing at an average annual rate of around 30 per cent since 1995. As at December 2005, total assets of securitisation vehicles



⁷ See Bailey, K, M Davies and L Dixon Smith (2004), ‘Asset Securitisation in Australia’, Financial Stability Review, September.

Graph 9
Australian Asset-backed Securities
 End December



amounted to about \$170 billion – around 7 per cent of total financial system assets. In contrast, in 1990, securitisation vehicles accounted for less than 1 per cent of total assets. As a result of this growth, Australian mortgage-backed securities issuance ranks only behind the United States and the United Kingdom in size.

Securitisation has had a profound effect on the structure of the mortgage market in Australia. Prior to the mid 1990s, lending for housing was largely the preserve of deposit-taking institutions. Access

to securitisation markets, however, intensified competition in the mortgage market as smaller regional deposit-taking institutions and specialised mortgage originators were able to fund themselves by pooling mortgages through securitisation vehicles. The share of housing lending by non-bank mortgage originators has more than doubled since 1995, and they accounted for around one third of the asset-backed securities issued in 2005. ❧

APPENDIX

Main Types of Financial Intermediaries

As at December 2005

Type of intermediary	Main supervisor/regulator	Main characteristics	Total assets (\$b)
Authorised deposit-taking institutions (ADIs)			
Banks	APRA	Provide a wide range of financial services to all sectors of the economy, including (through subsidiaries) funds management and insurance services. Foreign banks authorised to operate as branches in Australia are required to confine their deposit-taking activities to wholesale markets.	1 451
Building societies	APRA	Raise funds primarily by accepting deposits from households, provide loans (mainly mortgage finance for owner-occupied housing) and payments services. Traditionally mutually owned institutions, building societies increasingly are issuing share capital.	17
Credit unions	APRA	Mutually owned institutions, provide deposit, personal/housing loans and payments services to members.	35
Non-ADI financial intermediaries			
Money market corporations (excluding those with assets < \$50m)	ASIC	Operate primarily in wholesale markets, borrowing from, and lending to, large corporations and government agencies. Other services, including advisory, relate to corporate finance, capital markets, foreign exchange and investment management.	75
Finance companies (excluding those with assets < \$50m)	ASIC	Provide loans to households and small to medium-sized businesses. Finance companies raise funds from wholesale markets and, using debentures and unsecured notes, from retail investors.	92
Securitisation vehicles	–	Special purpose vehicles that issue securities backed by pools of assets (e.g. mortgage-based housing loans). The securities are usually credit enhanced (e.g. through use of guarantees from third parties).	194 ^(a)

Type of intermediary	Main supervisor/regulator	Main characteristics	Total assets (\$b)
Funds managers and insurers			
Life insurance companies	APRA	Provide life, accident and disability insurance, annuities, investment and superannuation products. Assets are managed in statutory funds on a fiduciary basis, and are mostly invested in equities and debt securities.	195 ^(a)
Superannuation and approved deposit funds (ADFs)	APRA	Superannuation funds accept and manage contributions from employers (including self-employed) and/or employees to provide retirement income benefits. Funds are controlled by trustees, who often use professional funds managers/advisers. ADFs are generally managed by professional funds managers and, as with superannuation funds, may accept superannuation lump sums and eligible redundancy payments when a person resigns, retires or is retrenched. Superannuation funds and ADFs usually invest in a range of assets (equities, property, debt securities and deposits).	505 ^(a)
Public unit trusts	ASIC	Unit trusts pool investors' funds, usually into specific types of assets (e.g. cash, equities, property, money market investments, mortgages and overseas securities). Most unit trusts are managed by subsidiaries of banks, insurance companies or money market corporations.	203 ^(a)
Cash management trusts	ASIC	Cash management trusts are unit trusts which are governed by a trust deed and open to the public and generally confine their investments (as authorised by the trust deed) to financial securities available through the short-term money market.	38 ^(a)

Type of intermediary	Main supervisor/regulator	Main characteristics	Total assets (\$b)
Trustee companies (Common funds)	State authorities	Trustee companies pool into common funds money received from the general public, or held on behalf of estates or under powers of attorney. Funds are usually invested in specific types of assets (e.g. money market investments, equities and mortgages).	10 ^(a)
Friendly societies	APRA	Mutually owned co-operative financial institutions offering benefits to members through a trust-like structure. Benefits include investment products through insurance or education bonds, funeral, accident, sickness, or other benefits.	5 ^(a)
General insurance companies	APRA	Provide insurance, including for property, motor vehicles and employers' liability. Assets are invested mainly in deposits and loans, government securities and equities.	104 ^{(a)(b)}
<p>(a) Consolidated basis (b) September 2005</p>			