Developments in the Structure of the Australian Financial System

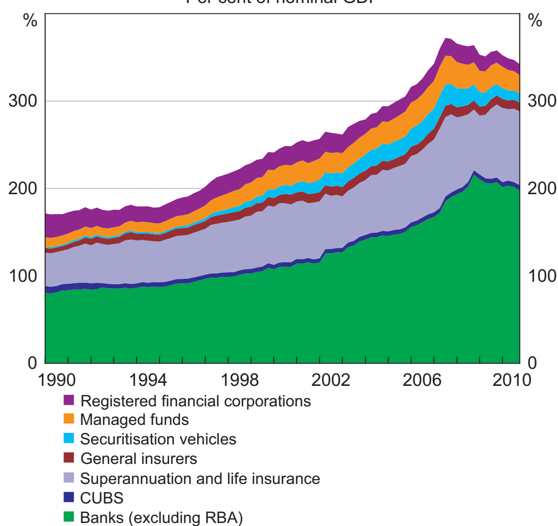
Bernadette Donovan and Adam Gorajek*

Some countries' financial systems have undergone significant changes in response to the global financial crisis. While Australia's financial system also experienced a variety of pressures and changes as a result of the crisis, the overall effect was much less severe than in some other developed countries and some of the recent changes in the structure of the Australian financial system have been a continuation of longer-term trends. This article examines recent developments in the institutional structure and performance of the Australian financial system, focusing on the past five years or so since the Reserve Bank published an article on this subject.[1]

Introduction

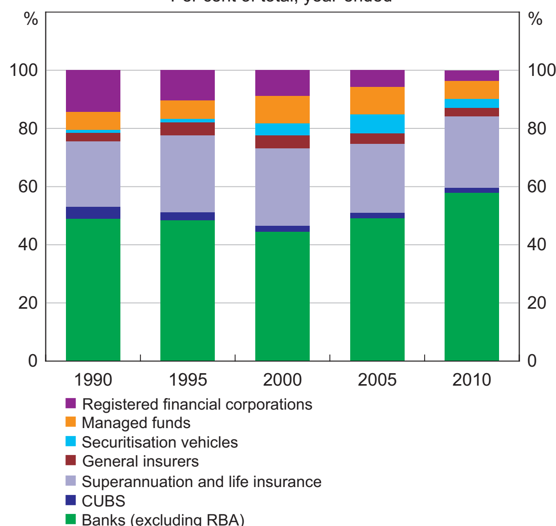
In aggregate, Australian financial institutions held assets of around $4.6 trillion in December 2010, equivalent to nearly 3½ times nominal GDP. After significantly outpacing growth in nominal GDP for much of the previous two decades, financial system assets have grown a little slower than GDP since around 2007 (Graph 1). The largest group of financial institutions are authorised deposit-taking institutions (ADIs), comprising banks, as well as credit unions and building societies (CUBS), which together account for nearly 60 per cent of financial system assets (Graph 2). The share of financial system assets held by ADIs has been growing over the past two decades. Life insurance companies, general insurance companies, and superannuation funds account for around one-quarter of financial system assets, a share that has been broadly unchanged for around a decade. The Australian Prudential Regulation Authority (APRA) regulates ADIs, life and general insurers, and the superannuation industry (excluding self-managed superannuation funds).

Other financial institutions, such as registered financial corporations, securitisation vehicles and managed funds account for a relatively small and declining share of the financial system (13 per cent, down from 22 per cent in 2005). These institutions are not regulated by APRA but they are subject to licensing, conduct and disclosure obligations administered by the Australian Securities and Investments Commission (ASIC) under the *Corporations Act 2001*.



* The authors are from Financial Stability Department.

1 See RBA (2006) for the previous overview of the structure of the financial system.



The structure of the Australian financial system has been relatively stable compared with some other developed countries over the past five years, despite the pressures arising from the global financial crisis. The remainder of this article provides an overview of the key changes in the institutional structure and performance of the Australian financial system since 2005 and describes some key characteristics of financial institutions. This article builds on earlier Reserve Bank work which reviewed developments in the Australian financial system over the two decades to 2005.[2]

Authorised Deposit-taking Institutions

Institutional structure

Among the key developments over the last five years or so were that ADIs increased their share of financial system assets, shifted the composition of their balance sheet, and in particular improved their funding and capital positions. They constitute the largest part of the Australian financial system and their share of financial system assets has risen from about 50 per cent in 2005 to nearly 60 per cent in 2010. This increase was supported by high rates of credit growth before the financial crisis, particularly to the household sector. But in more recent years, credit growth has slowed as the one-time boost to credit growth from financial deregulation and the shift to low inflation has passed.

Banks account for 97 per cent of ADI assets in Australia. Within the banking system, Australia's four largest banks – ANZ Banking Group, Commonwealth Bank of Australia, National Australia Bank and Westpac Banking Corporation – together have around $1.9 trillion of assets on their domestic books, and account for about three-quarters of ADI assets (Table 1). Each of these major banks also has some operations overseas, principally in New Zealand but also, to a lesser extent, in the United Kingdom and elsewhere. Overseas assets account for about one-quarter of the major banks' globally consolidated assets, a share that has been broadly unchanged since 2005. The banks' subsidiaries in these countries have generally the same retail-focused business model as their Australian parents.

The major banks are reasonably large by international standards with each ranking, in terms of consolidated group assets, among the top 60 banks worldwide. However, their share of global banking sector assets is estimated at about 2 per cent, which is similar to Australia's share of global GDP and other indicators of the relative size of Australia in the global economy.

Since 2005, the major banks have increased their share of ADI assets in Australia by about 10 percentage points. This was partly due to two acquisitions of smaller banks in late 2008: Westpac acquired St. George Bank in December 2008, which was the fifth largest bank at the time, and Commonwealth Bank acquired the foreign-owned Bankwest in October 2008, which was the eighth largest bank at the time.

2 See RBA (2006) for the previous overview of the structure of the financial system.

Table 1: Australian ADIs[a]

	Number	Australian assets $billion	Per cent of total
December 2010			
Major banks[b]	4	1 887	75
Other Australian-owned banks	7	221	9
Foreign-bank subsidiaries	9	110	4
Foreign-bank branches	34	229	9
Credit unions and building societies	116	76	3
Total	**170**	**2 524**	**100**
December 2005			
Major banks[b]	4	918	65
Other Australian-owned banks	9	193	14
Foreign-bank subsidiaries	11	103	7
Foreign-bank branches	28	140	10
Credit unions and building societies	170	52	4
Total	**222**	**1 406**	**100**

(a) Excludes specialist credit card institutions, providers of purchased payment facilities and ADIs providing specialist services to CUBS
(b) Subsidiaries of the major banks are consolidated into their parent bank
Source: APRA

Aside from the four major banks, Australia's banking system currently consists of seven other Australian-owned banks (9 per cent of ADI assets) and 43 foreign-owned banks operating either as branches and/or locally incorporated subsidiaries (13 per cent of ADI assets). In terms of their domestic assets, these smaller banks range in size from about $40 million to $70 billion, compared with $360 billion for the smallest of the four major banks. Since 2005, the number of other Australian-owned banks and foreign-bank subsidiaries has declined and their share of ADI assets has fallen. Aside from Westpac's acquisition of St. George Bank, there was a merger of two mid-sized Australian banks (Adelaide Bank and Bendigo Bank) in 2007, and a reduction in the share of ADI assets held by foreign-owned banks, largely the result of Commonwealth Bank's acquisition of Bankwest. Other factors also contributed: some foreign-owned banks reduced their domestic lending in the wake of the crisis, while others withdrew from the Australian market altogether. Recently there have been indications that foreign-owned banks are beginning to increase their domestic lending again, and there has also been interest from a number of other foreign-owned banks to begin operating in Australia for the first time.

CUBS account for the remaining 3 per cent of ADI assets in Australia, down from 4 per cent in 2005. CUBS range in asset size from just under $3 million to nearly $7 billion, though the majority have assets of less than $1 billion. Most have a mutual ownership structure where customers are also the 'shareholders'. The trend since the 1980s has been for CUBS to consolidate, and this has continued in recent years. Since 2005, the total number of CUBS has fallen from 170 to 116, comprising 11 building societies and 105 credit unions, mostly due to mergers and acquisitions within the sector and, to a lesser extent, acquisitions by banks. CUBS

have been motivated to consolidate mainly by the benefits of economies of scale and scope, and the perception that bigger institutions can compete more effectively with the banks.[3]

Business focus and performance during the crisis

While there is some differentiation among individual institutions, the primary business focus of Australian ADIs continues to be on traditional banking services – deposit taking and lending – provided to the domestic market. Domestic lending accounts for over two-thirds of ADIs' on-balance sheet assets, most of which is to the retail sector, while deposits account for nearly 50 per cent of their liabilities, a share that has increased significantly in the post-crisis environment (see below). For the smaller ADIs, such as CUBS and some of the smaller Australian-owned banks, retail lending accounts for an even larger share of their balance sheets, and in some cases is as high as 85 per cent. They typically also source a higher proportion of their funding from deposits than the larger institutions. Reflecting this focus, net interest income and banking-related fees account for the bulk of most ADIs' operating income at around 70 per cent.[4]

The larger banks are involved in a range of other banking activities, including business financing, securities underwriting, risk management services, transactions services, trading in financial markets, and stockbroking. Unlike some of their large international peers, however, Australian banks have had very limited involvement in securities trading activities on their own account. Consistent with this, the larger banks have typically earned only about 5 per cent of their income from trading activities. It is therefore not surprising that they had not built up material exposures to the kinds of US structured credit securities that caused large asset write-downs for some of the larger international banks during the crisis.

In addition to their banking activities, many Australian-owned banking groups (including the four major banks) have sizeable funds management operations in Australia and, to a lesser extent, overseas. Typically, these businesses account for a smaller share of their income than their banking operations, ranging from about 5 to 15 per cent of consolidated group income for the major banks. Two Australian-owned banks, Suncorp Bank and AMP Bank, belong to financial groups that generate more of their income from insurance and funds management activities than from banking activities. Macquarie Bank – the sixth largest Australian-owned bank in terms of domestic banking sector assets – undertakes predominantly investment banking activities, generating around two-thirds of its net operating income from trading income, and fees and commissions.

An essentially uninterrupted period of economic growth from the early 1990s, combined with a rapid expansion of household balance sheets, enabled the banking system in Australia to grow continuously and maintain a fairly consistent profit stream for much of the past two decades. The post-tax return on equity for the major banks has averaged around 15 per cent since 1992 (Graph 3). The smaller Australian-owned banks have experienced broadly similar average returns over this period, though with somewhat greater volatility. These returns are similar to those of other major companies in Australia as well as those of banks in other countries prior to the global financial crisis.[5]

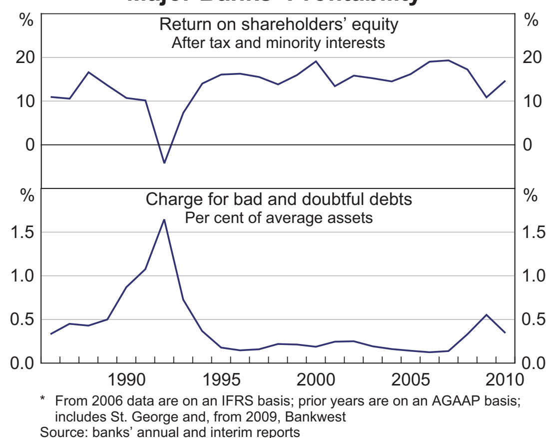
The Australian banking sector experienced a downturn in profits during the crisis period, but earned solid profits overall. The decline in profitability was mainly due to sizeable increases in bad and doubtful debt charges in 2008 and 2009, although they were well below those observed in many other countries' banking systems. The

3 For more information on the longer-term decline in the number of CUBS, see RBA (2006).

4 For more information on bank fees, see RBA (2011b).

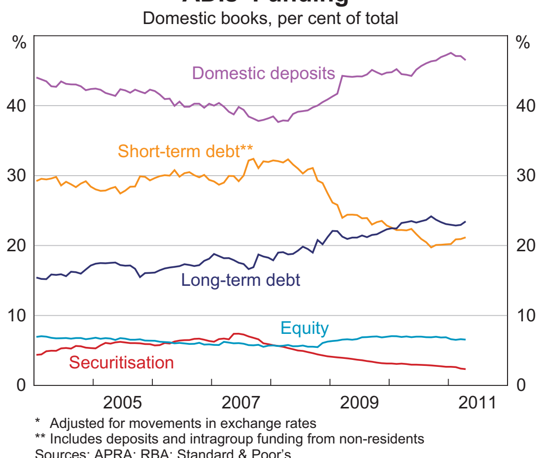
5 For more information see RBA (2010).

major banks' return on equity dropped to about 10 per cent in 2009, down from an average of about 20 per cent in 2006 and 2007, but has subsequently picked up to about 15 per cent in 2010 as bad and doubtful debt charges have declined. Smaller ADIs were more affected by the downturn than the major banks, but in general they remained profitable. The relative resilience of the Australian banking sector during the crisis reflects a number of interrelated factors. These include the relatively mild economic downturn experienced in Australia; the ADIs' focus on domestic lending; and a strong regulatory and institutional environment that promoted prudent lending standards before the crisis.



While banks continued to generate profits throughout the crisis, and asset quality weakened only modestly, they were not immune to the funding challenges that arose after the collapse of Lehman Brothers in September 2008. As in many other countries, banks' access to funding in offshore wholesale markets became impaired and securitisation markets effectively shut down (see below). In response, the Australian Government introduced a temporary fee-based guarantee on ADIs' wholesale funding in October 2008 to support ADIs' funding needs.[6] At its peak, nearly $160 billion of ADIs' wholesale liabilities were guaranteed under the scheme, equivalent to about 15 per cent of their funding liabilities at the time. The scheme was closed to new issuance in March 2010, by which time funding conditions had substantially recovered. As at April 2011, $118 billion of guaranteed wholesale liabilities were outstanding and are due to run off over the next four years.

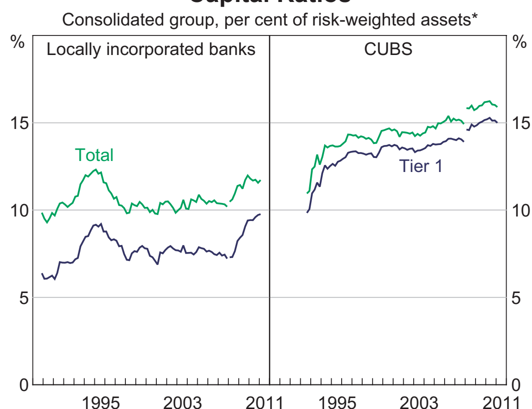
In response to the events of the crisis and the market pressures that have emerged since, as well as in anticipation of stronger global prudential regulatory standards, ADIs in Australia have sought to strengthen their funding and liquidity profiles by reducing their use of short-term wholesale funding and increasing their holdings of liquid assets. Short-term wholesale funding as a share of total ADI funding has fallen from around one-third in the years leading up to the crisis, to around one-fifth, and has been replaced by long-term wholesale debt and deposit funding sources typically regarded as more stable (Graph 4). The deposit share of ADI funding has increased from around 38 per cent to 47 per cent since early 2008, fuelled by strong competition for



6 For more information on the Government Guarantee Scheme see Schwartz (2010).

deposits among ADIs.[7] The breakdown of funding sources is generally different at smaller ADIs, which tend to make less use of wholesale funding and rely more on deposit funding.

ADIs had strong underlying capital positions going into the crisis, partly because APRA had applied the Basel II capital rules more conservatively than some other prudential regulators.[8] Even so, banks have increased their capital ratios further over the past few years (Graph 5). The aggregate Tier 1 capital ratio of the Australian banking sector has increased by around 2 percentage points since 2005, to 9.8 per cent in March 2011. This is well above the Basel II minimum and is the highest level since the late 1980s (when standardised minimum capital requirements came into force). The increase in capital came from a combination of equity raisings and retained earnings; the public sector did not provide capital support to any Australian institution during the crisis. The banks have focused particularly on increasing their common equity in recent years, which now accounts for nearly three-quarters of the total gross capital of the banking sector, allowing their Tier 2 capital ratios to decline. The CUBS sector in Australia is also well capitalised, with the aggregate Tier 1 capital ratio drifting up since the mid 2000s, to around 15 per cent in 2010. As a result of the strengthening of capital ratios in recent years, Australian ADIs are well placed to meet the more stringent Basel III capital requirements being phased in over the next decade or so.



Registered Financial Corporations

Registered financial corporations (or RFCs) intermediate between lenders and borrowers, but they are not authorised to accept deposits, instead funding themselves through wholesale debt instruments. While they are required to be registered with APRA, and are subject to certain reporting requirements when their assets exceed $5 million, RFCs are not prudentially regulated by APRA. However, if they provide credit to consumers, or sell financial products or provide financial advice, then ASIC requires them to meet disclosure, licensing and conduct requirements. As well, RFCs are subject to the same market conduct and other obligations contained in the Corporations Act and administered by ASIC in respect of all companies.

The relative importance of RFCs in the Australian financial system has been declining and, as at December 2010, they held less than 4 per cent of financial system assets, down from 6 per cent in 2005.[9] As at end December 2010, around 130 registered financial corporations reported data to APRA, of which 21 are money market corporations and the remainder are finance companies. The size of reporting RFCs varies considerably, from the largest having assets of around $20 billion, while 30 or so have assets of $100 million or less. The majority of money market corporations are owned by foreign banks or securities firms and are typically involved in similar activities to investment banks in other countries. Many finance companies are involved in financing motor vehicle sales or the financing of machinery and equipment. A number

7 For more information on recent trends in bank funding and liquidity see RBA (2011a).

8 For more information on bank capital, see Gorajek and Turner (2010).

9 For more information on the activities of registered financial corporations, see RBA (2006).

of the larger finance companies are owned by Australian banks, and APRA's consolidated approach to supervising ADIs includes these subsidiaries.

Managed Funds

The managed funds sector includes assets invested by superannuation funds, life insurance companies and public unit trusts. In some cases, superannuation assets are managed by life insurance companies and other funds managers, so these holdings need to be netted out to obtain a consolidated figure which avoids double-counting. Total consolidated funds under management increased from $1 trillion in December 2005 to $1.4 trillion at end 2010, equivalent to about 30 per cent of financial system assets. Growth in funds under management has been slower over the past few years, compared with the longer-run trend, partly because of volatile investment returns during the crisis period.

Within the managed funds sector, superannuation funds are dominant and account for around 70 per cent of funds under management. The life insurance industry makes up around 13 per cent of the managed funds industry. It has increasingly focused on funds management rather than traditional life insurance business, with the industry's superannuation businesses continuing to account for the vast majority of its assets.

The remainder of the managed funds sector (for which official data are available) is accounted for by public unit trusts (such as property trusts and equity trusts), cash management trusts, common funds and friendly societies. Over the past five years, these institutions have held a smaller share of financial system assets. The attractiveness of cash management trusts has fallen, as ADIs have offered more competitive deposit products, and additional depositor protection has become available through the Financial Claims Scheme.[10]

10 The Financial Claims Scheme for depositors provides timely access to deposits up to a specified limit in the event of an ADI failure.

The superannuation industry in Australia is relatively large by international standards with unconsolidated assets of around $1.3 trillion as at December 2010 (Table 2). Around 2008, the industry had a period of negative investment returns associated with falls in domestic and global equity markets. Growth in funds under management at that time was limited by poor market returns, although compulsory employer contributions ensured a steady flow of new funds. Subsequently, asset growth has resumed and asset levels have surpassed their earlier peak in 2007.

The institutional structure of the superannuation sector has changed markedly over the past five years. The share of superannuation assets in self-managed funds has increased by around 10 percentage points; and the share of superannuation assets in industry funds, which traditionally catered for employees in a particular sector of the economy, has increased by around 2½ percentage points (Graph 6). This continues a trend apparent since the mid 1990s (when data first became available) for both fund types to steadily increase their share of industry assets.

Despite the changes in the sector's institutional composition over recent years, the overall investment mix has been fairly stable. By investment type, the largest share of funds are

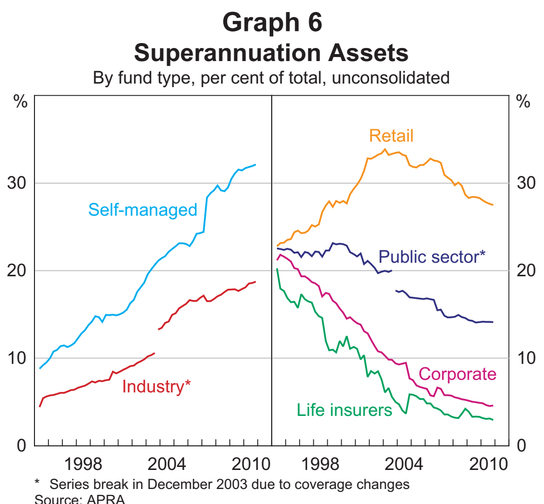


Table 2: Assets of Managed Funds

	Dec 2010		Dec 2005	
	Level	Share of total	Level	Share of total
	$billion	Per cent	$billion	Per cent
Superannuation funds	**1 274**	**69**	**793**	**59**
of which:				
Equities	364	29	211	27
Assets overseas	179	14	135	17
Units in trusts	176	14	114	14
Net equity in life offices	168	13	152	19
Deposits	159	12	60	8
Land, buildings and equipment	79	6	33	4
Short-term securities	54	4	28	4
Long-term securities	52	4	43	5
Other assets in Australia	33	3	11	1
Loans and placements	11	1	5	1
Life insurers[(a)]	**233**	**13**	**238**	**18**
Public unit trusts	**288**	**16**	**254**	**19**
of which:				
Listed property trusts	125	43	93	37
Unlisted equity trusts	98	34	89	35
Listed equity trusts	39	13	37	15
Other trusts	26	9	34	13
Other managed funds[(b)]	40	2	57	4
Total (unconsolidated)	**1 834**	**100**	**1 342**	**100**
of which:				
Cross investments	414		343	
Total (consolidated)	**1 420**		**999**	

(a) Includes superannuation assets held in statutory funds of life insurers
(b) Cash management trusts, common funds and friendly societies
Sources: ABS; RBA

allocated to domestic equities, at almost one-third, while overseas assets, units in trusts, life offices and deposits each account for between 12 and 14 per cent of funds. A notable exception to the stable investment mix has been the rise in the share of assets invested in deposits from 8 per cent to 12 per cent. This is likely to be in response to the more attractive interest rates now available on deposits as well as greater caution and lower risk appetite reducing somewhat the appeal of other investments; funds are also paying more attention to their own liquidity needs following the experience of the crisis.

Defined-benefit schemes have accounted for around 10 per cent of the superannuation industry since 2005, after declining in importance for at least the previous decade. The rest of the superannuation industry is roughly evenly divided between defined-contribution funds, where the investor's return depends entirely on the market performance of their invested assets, and 'hybrid' schemes, which comprise a combination of defined-benefit and defined-contribution characteristics.

The assets of life insurers have increased more slowly than those of superannuation funds. Like superannuation funds, a large portion of life insurers' assets are in the form of equities and units in trusts. The profits of life insurers have been weaker in recent years due to lower investment returns, but in 2009/10 they returned to more typical levels.

Hedge funds are included within the managed funds data, although they are not able to be identified separately from other fund types. Separate surveys indicate that this segment is still relatively small in Australia, with total assets under management estimated at around $50 billion as at September 2010.

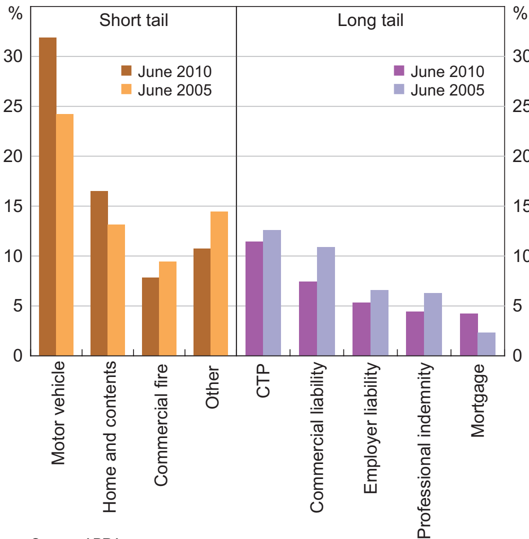
General Insurance

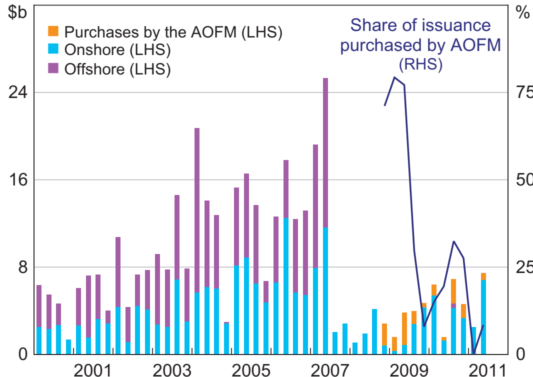
As at end 2010, Australian general insurance companies had assets of $133 billion, accounting for around 3 per cent of financial system assets. There are 116 licenced general insurers and 12 reinsurers in Australia, with the total number remaining relatively steady over the past five years. The general insurance industry is fairly concentrated, with the three largest institutions (Suncorp, QBE and IAG) accounting for just over half of industry assets as at June 2010. Since 2005, this share has grown, mainly because of the merger of Suncorp and Promina in 2007, which were two of the largest domestic insurance groups at the time.

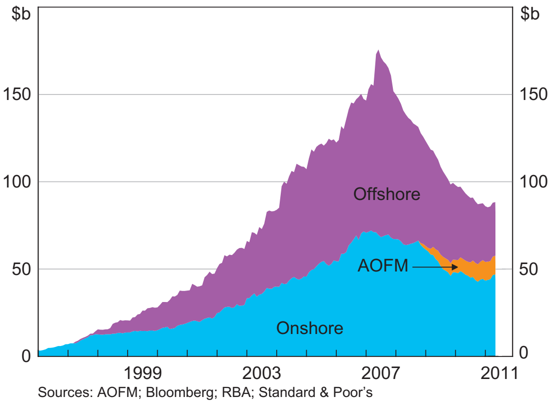
The general insurance industry has generally recorded solid profits over the past five years. The industry's post-tax return on equity declined from around 18 per cent in 2007 to 9 per cent in 2009 due to weaker underwriting results and interest rate movements, before recovering to around 15 per cent in 2010 which is roughly in line with the average over the past decade. The contribution of investment income to industry profits over the past five years has been broadly stable, despite share market volatility, reflecting the relatively large share of fixed-interest assets in their portfolios. General insurers are well capitalised, with the industry as a whole holding around double the regulatory minimum amount of capital.

In terms of business activities, around two-thirds of insurers' revenue comes from 'short tail' policies, providing cover for risks against losses that are typically incurred within 12 months of receipt of premiums (Graph 7). The most prominent examples are motor vehicle insurance and home insurance. Their remaining policies are 'long tail', such as professional indemnity insurance and mortgage insurance. Some of the change in the share of premium revenue earned from short tail versus long tail policies has been due to differing levels of competition in different product lines.

In addition to diversified insurers, there are insurers who specialise in particular market segments, such as lenders' mortgage insurers (LMIs). LMIs provide insurance to ADIs and other lenders to reimburse them against shortfalls following a default and sale of a mortgaged property. In Australia, the provision







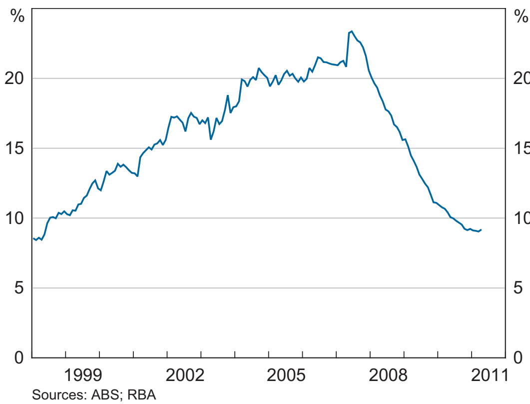
of lenders' mortgage insurance is dominated by two institutions, Genworth and QBE, following QBE's purchase of PMI in 2008. The other main participants are three so-called captive LMIs, owned by two of the major banks, and used to self-insure a portion of their loans.

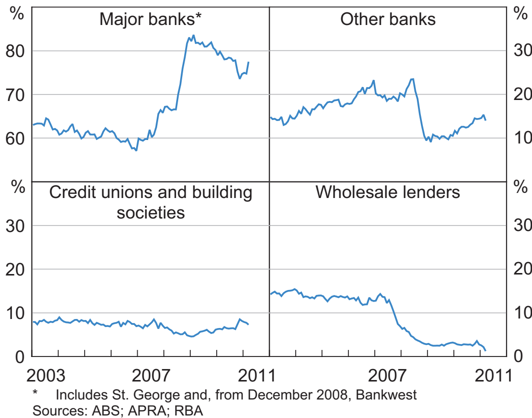
Securitisation

Another change in the structure of the financial system over the past five years has been a reduced reliance on securitisation funding. From around the mid 1990s until the crisis, the securitisation market in Australia expanded rapidly.[11] The size of securitisation vehicles reached 7 per cent of financial system assets in mid 2007 but declined to 3 per cent as at December 2010, due to the problems that emerged in US residential mortgage-backed securities (RMBS) markets in 2007 causing severe brand damage to securitisation markets globally. Most securitisation in Australia involves RMBS, and even though the collateral underlying Australian RMBS continued to perform strongly, the issuance of RMBS in Australia slowed significantly from late 2007 (Graph 8). The value of outstanding RMBS has halved, particularly for offshore holdings (Graph 9).

When securitisation issuance fell sharply in 2007, the share of outstanding housing loans funded through securitisation declined sharply (Graph 10). Lenders who had relied heavily on securitisation experienced significant falls in their market share. The major banks' share of new housing loan approvals increased from about 60 per cent in 2007 to over 80 per cent in 2008 (Graph 11). To support competition in the housing loan market, the

11 For more information on the securitisation market, see Debelle (2010).





Australian Office of Financial Management (AOFM) was mandated by the Treasurer in September 2008 to purchase up to $8 billion of RMBS, with $4 billion to be made available to non-ADI mortgage originators. The program was extended by a further $8 billion in October 2009 and another $4 billion in December 2010. The proportion of new RMBS issuance supported through purchases by the AOFM has been declining as RMBS issuance has been slowly recovering.

Conclusion

ADIs hold the largest share of financial system assets and their share has been growing over the past five years, continuing a longer-term trend. Within the ADI sector, there has been consolidation, particularly during the financial crisis, and there are fewer institutions, especially in the CUBS sector. ADIs remained profitable overall during the financial crisis, as their business focus underpinned their profitability, although they still underwent a number of changes in response to the crisis. Like many other deposit-taking institutions around the world, ADIs have strengthened their capital position, and improved the resilience of their funding by increasing the proportion sourced from deposits and longer-term securities.

The superannuation sector continues to grow, although lower investment returns have slowed the average pace of growth over the past five years. There has been considerable change in the types of funds managing superannuation assets, with self-managed and industry funds increasing their market shares over this period.

As with ADIs, concentration within the general insurance industry has increased over the past five years, owing mostly to merger activity. The industry's business activities have, however, been broadly unchanged over recent years. General insurers maintain a relatively conservative investment mix, consistent with the typically short-term nature of the insurance policies they write.

Securitisation vehicles have decreased their share of financial system assets, following the damage to the reputation of securitisation during the financial crisis. This has reduced the market shares of lenders in the residential mortgage lending market who relied most heavily on this source of funding, and the share of housing credit funded by securitisation over the past five years. In the latest year, however, the smaller lenders have begun to recover market share as conditions in securitisation markets have improved. ✵

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