# The Australian Financial System

## Introduction

2.1 This chapter provides an overview of the main institutions, markets and products which constitute the Australian financial system.

2.2 It begins with a brief summary of how the system and its regulatory framework have evolved. This is followed by a description of the main institutions and markets of the system.

2.3 The purpose of this chapter is to introduce the industries and products which are the subject of the Inquiry. A full analysis of the forces which have shaped the existing arrangements, including financial system deregulation, is not provided here. This analysis, which is required by the Inquiry's Terms of Reference, will be provided in the Final Report.

2.4 The financial system is undergoing rapid change. A 'snapshot' of the system at any moment in time reflects the influence both of past developments and of the forces for change now acting upon the system. In Chapter 3, these forces for change are identified and their likely future impact is discussed as a way of introducing the major task facing the Inquiry — recommending an appropriate regulatory framework for the Australian financial system.

## Fifty Years in a 'Nutshell' — the Evolution of Australia's Financial System

2.5 Following the Great Depression of the 1930s and the Second World War (1939-45), a comprehensive regulatory structure was imposed on the Australian banking system. During the ensuing 40 or so years to the early 1980s, the evolution of financial institutions was driven, at least in part, by their efforts to minimise or avoid the constraints imposed by regulation.

2.6 In this period, the focus of regulation was on the tight control of banks, which dominated the financial system. The larger private banks established savings bank subsidiaries in the second half of the 1950s partly in an attempt to avoid regulatory constraints. However, these subsidiaries were also licensed and required to hold specified proportions of reserves and government securities. Another development was the establishment and growth of finance companies (often bank subsidiaries), again driven in part by the regulatory advantages applying to these companies compared with banks. Similarly, non-bank deposit-taking institutions such as building societies and credit unions increased their market share as a result of their regulatory advantages.

2.7 Throughout this period, life offices and superannuation funds together held assets equal to about one third of those of the banks. Both of these longer-term savings vehicles benefited from considerable taxation advantages. In 1961, the Government introduced a requirement that life insurance and superannuation funds hold 30 per cent of their assets in the form of government securities, at least two thirds of which had to be Commonwealth Government securities. This so-called '30/20 rule' was driven by a perceived need to ensure a market for government debt.

2.8 Life offices, finance companies and building societies were all involved in the provision of mortgage lending to satisfy demand not met by banks, the latter being constrained by lending guidelines.

2.9 The sectors with regulatory advantages tended to increase their share of financial system assets. This reduced the effectiveness of regulation both for prudential purposes and for the conduct of monetary policy, both of which were focused primarily on banks.

2.10 In the late 1960s and early 1970s, it was increasingly recognised that direct regulation of institutions was not achieving its objectives. An initial attempt at modest deregulation in the 1970s was largely reversed towards the end of that decade when credit restrictions were reapplied.

2.11 The Campbell Inquiry was announced in 1979, with a mission to examine the growing distortions and inefficiencies created by regulation, particularly of banks. The recommendations of the Inquiry published in 1981 included floating the exchange rate, removing quantitative controls on bank lending, lowering bank reserve requirements and increasing competition through foreign bank participation.

2.12 The key recommendations of the Campbell Committee were endorsed by the Australian Financial System Review Group (the Martin Committee) in December 1983. The overwhelming majority of the recommendations have since been introduced, albeit over a prolonged period. As a result, the financial sector over the past decade has experienced:

- new entry to the banking industry, by both local and foreign institutions;
- globalisation of Australia's capital markets, with a floating dollar and removal of virtually all exchange controls, resulting in the closer integration of Australian and foreign financial markets; and
- some increase in the market share of banks in the deposit-taking sector, at the expense of other financial institutions.

2.13 The same period has also seen other regulatory changes introduced, largely unrelated to the Campbell Committee recommendations. Among those which have influenced the development of the financial system are:

- major reform and expansion of the occupational superannuation arrangements, in response to increasing government and community concern at the retirement income needs of an ageing population;

- introduction of new prudential imposts in response to financial sector difficulties occasioned by major swings in asset prices in the late 1980s and early 1990s;
- introduction of full dividend imputation and privatisation of some major government businesses, which have helped to invigorate the domestic equities markets;
- substantial exit from banking and insurance of government-owned enterprises; and
- introduction of new consumer protection regulations.

2.14 Regulatory changes have been accompanied by major changes in market structure, technology, distribution arrangements and financial products. In particular, derivatives markets have seen rapid growth as market participants have embraced the capacity they provide to manage financial risks. Regulatory and other changes have combined in a complex interplay to bring the financial system to its present position.

2.15 Nothing is more certain than further evolution, both from the continued playing out of the changes already under way and from new developments yet to be established. These directions and forces for change are reviewed in Chapter 3. The remainder of this chapter considers in more detail the institutions and markets which constitute the Australian financial system.

2.16 As noted in Chapter 1, the financial system performs a variety of functions which are conducted either through financial intermediaries or through financial markets.

- Financial intermediaries are institutions standing between savers and borrowers (or more generally between those with financial surpluses and those with deficits) and include banks, non-bank deposit-taking institutions, life offices, general insurance companies, superannuation funds, other collective investment funds and several other types of entities.
- Financial markets include exchanges and over the counter (OTC) markets, in which financial assets are directly traded between participants (either financial intermediaries or ultimate borrowers and lenders).

# Financial Intermediaries

## Overview

2.17 The largest part of the system comprises financial intermediaries, broadly defined to include not only banks and insurance companies but also managed funds such as superannuation and collective investment schemes. The level of assets held by financial intermediaries is indicative of the depth of the financial system and its ability efficiently to allocate available financial resources. By this measure, the Australian financial system is deeper now than ever before in the past 35 years. The total value of assets held by such intermediaries, excluding those held by the Reserve Bank of Australia (RBA), was estimated to be approximately $931 billion[1] in 1995. These assets had grown from around 78 per cent of gross domestic product (GDP) in 1960 to about 204 per cent of GDP in 1995.[2]

2.18 The volume of financial assets as a proportion of GDP has increased in virtually all major countries over the past twenty years or so.[3]

2.19 Over the past decade or so in Australia, there have been two major trends in the financial intermediation sector:

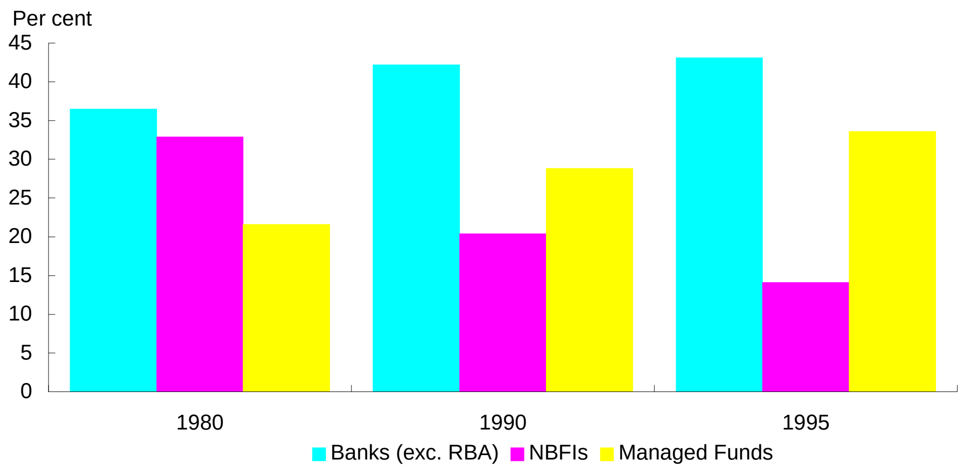
- overall, managed funds growth has outstripped the growth of the other sectors, due mainly to the strong relative growth of the superannuation savings pool; and
- the licensed bank sector has nonetheless increased its share of financial system assets, due mainly to the granting of bank licences to foreign-owned money market corporations, the absorption of bank-owned finance company subsidiaries into parent banks and the granting of banking licences to a number of former building societies.

1 Note: $ refers to Australian dollars.
2 Australian Bureau of Statistics cat. no. 5206.0 1996; *Reserve Bank of Australia Bulletin*, September 1996.
3 Davis, E. Philip 1996.

The net effects of these trends are illustrated in Figure 2.1.

## *Change in the Financial Institutions Landscape . . .*

Figure 2.1: Assets of Banks, Non-Bank Financial Institutions and Managed Funds as a Proportion of Total Assets of Financial Institutions[4]



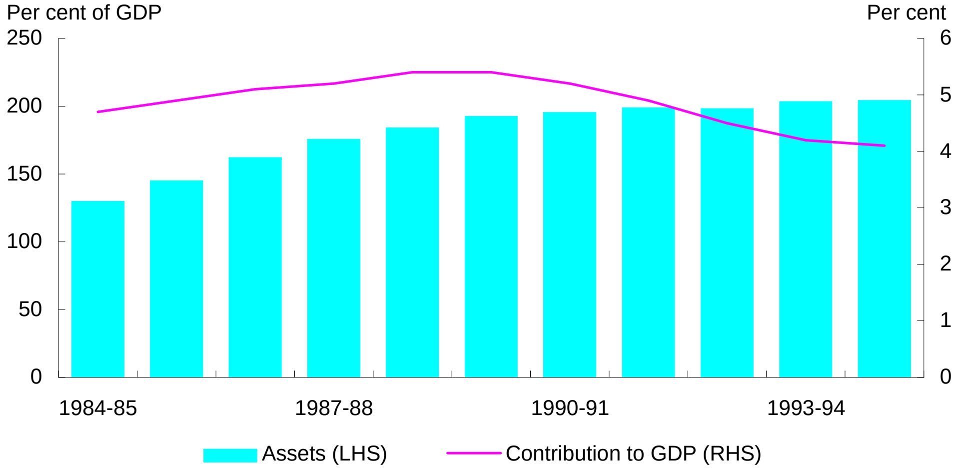

Source: *Reserve Bank of Australia Bulletin*, September 1996.

2.20 Despite the dramatic increase in assets of the financial intermediation sector, the industries responsible for managing these assets are using fewer resources to do so. The national accounts measure of the contribution to GDP of the finance and insurance sector (ie the proportion of national resources devoted to this sector) decreased from a peak of 5.4 per cent in 1989-90 to 4.1 per cent in 1994-95 (see Figure 2.2). Thus, a much greater stock of assets is administered at a relatively smaller cost in national resources. This relative decline points to substantially increased efficiency in the financial system.

4 Non-bank financial institutions (NBFIs) as defined here include building societies, credit unions, authorised money market corporations, finance companies, general financiers and pastoral finance companies (see paragraph 2.29). Managed funds include life offices and superannuation funds, cash management trusts, common funds, friendly societies and public unit trusts (see paragraph 2.46).

## *Assets are Increasing, but Resources used to Manage those Assets are Falling . . .*

Figure 2.2: Assets of the Australian Financial System as a Percentage of GDP, and Banking and Insurance Sector Contribution to GDP, 1984-1995

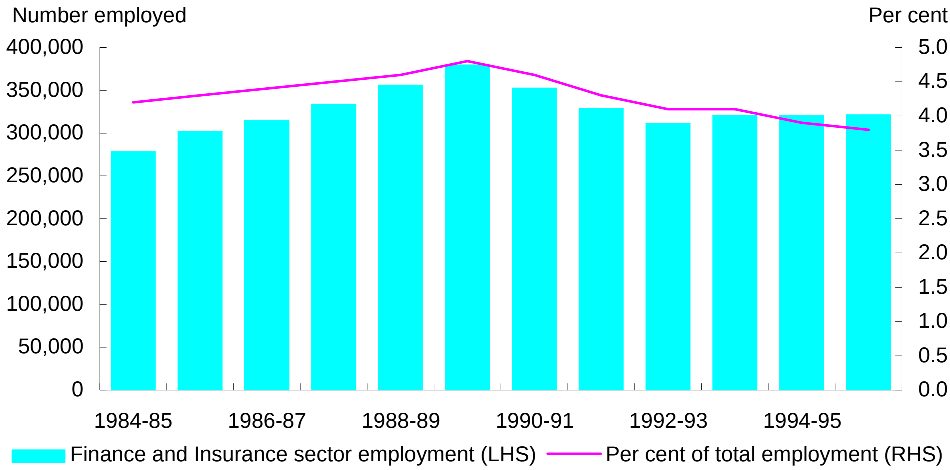



Source: Australian Bureau of Statistics cat. no. 5206.0 1996; *Reserve Bank of Australia Bulletin*, September 1996.

2.21 The decline in the relative contribution of the banking and insurance sector to GDP is also reflected in employment. In total, the Australian financial system employed approximately 321,600 people ANZSIC category finance and insurance), or 3.8 per cent of total employees in Australia in 1995-96, down from a peak of 379,800, or 4.8 per cent of total employees, in 1989-90 (see Figure 2.3).

## *Falling Employment during the 1990s . . .*

Figure 2.3: Finance and Insurance Sector Employment




Source: Australian Bureau of Statistics cat. no. 6203.0-D 1996.

2.22 The remainder of this section provides detail on the major financial intermediaries which make up the greater part of the Australian financial system and on the products and services they provide. For the purposes of this discussion, a distinction has been drawn between deposit-taking financial intermediaries (which act primarily as deposit-taking and lending institutions) and insurance, superannuation and managed funds intermediaries (which act primarily as insurers or investment vehicles). In addition to summarising the structure of each sector, this section makes some limited observations on major changes, including product developments, now under way in each sector.

2.23 The discussion of products and services is not comprehensive, omitting several financial services such as the provision of financial advice. The focus is on the instruments used for payments, savings, borrowings, risk management and investment. These instruments are increasingly being offered by a wide range of intermediaries in competition with traditional and new providers. For example, banks and insurance companies are offering their customers insurance and banking products, respectively. Nevertheless, for presentational purposes, the products are discussed in the section dealing with the sector which, for the time being at least, commands the larger market share.

2.24 This discussion is restricted to retail products, which are defined broadly as the products and services used by individual consumers and small businesses. It is recognised that virtually all 'retail' products have at least some wholesale elements (wholesale products being defined as those used by larger corporations and government), and vice versa. Some details on wholesale products are provided in the discussion of financial markets later in this chapter.

## Deposit-Taking Sector

2.25 The main institutions in the deposit-taking sector are banks and NBFIs, such as building societies and credit unions. The primary products and services of this sector are payments and transaction services, credit and deposit products.

### *Institutions*

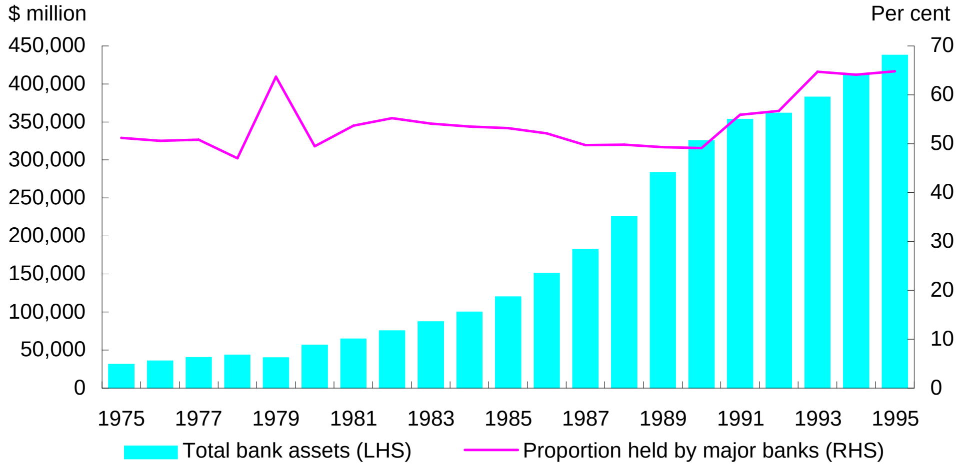
#### Banks

2.26 In 1995, there were 50 banks operating in Australia, including those entities licensed as banks under the *Banking Act 1959*, and the RBA. The assets of these banks (excluding the RBA) totalled $438 billion in 1995, 65 per cent of which were held by the 4 largest banks[5] (see Figure 2.4). Twenty-five of the 50 organisations were foreign-owned entities, representing 13 per cent of the banking sector's total assets.

5 From 1989 the major banks comprise the Commonwealth Bank of Australia, ANZ Banking Group, National Australia Bank and Westpac Banking Corporation and their main savings bank subsidiaries. Prior to 1989 this series refers to the group known as the major trading banks. From 1975 until 1980 there were 7 major trading banks. Between 1980 and 1982 3 mergers took place, effectively leaving the 4 current major banks.

## *Bank Assets Growing — Majority Held by the Major Banks . . .*

Figure 2.4: Major Banks' Assets as a Proportion of Total Bank Assets




Source: Foster, R.A. 1996.

2.27 Despite the strong trend increase in the use of distribution channels other than branches (see the discussion of retail payments services which follows), bank branches and agencies still represent the major channel though which consumers transact with banks. In 1995, banks operated 6,655 branches and 5,897 agencies across Australia. Over recent years, the number of branches has reduced slightly (from a peak of 7,064 in 1993), as has the number of agencies. The break-up between metropolitan and non-metropolitan branches and agencies is set out in Table 2.1. The modest fall in the number of agencies results from a large fall in non-metropolitan agencies, offset by an increase in metropolitan agencies. The format and location of many branches have changed greatly, in part because banks have sought to reduce the cost of their networks.

## *Branch and Agency Numbers Falling . . .*

Table 2.1: Number of Bank Branches and Agencies in Australia

| | Branches | | | Agencies | | |
|---|---|---|---|---|---|---|
| | 1993 | 1995 | % Change | 1993 | 1995 | % Change |
| Metropolitan | 4,158 | 3,990 | -4.1 | 2,563 | 3,302 | +28.8 |
| Non-Metropolitan | 2,906 | 2,665 | -8.3 | 3,725 | 2,595 | -30.0 |
| **Total** | 7,064 | 6,655 | -5.8 | 6,288 | 5,897 | -6.2 |

Source: *Reserve Bank of Australia Bulletin*, December 1995.

2.28 Reflecting this reconfiguration as well as an attempt to reduce administrative overhead, total employment in retail banking fell from a peak of approximately 152,000 in 1990 to 106,000 in 1994.[6] Most industry participants expect this trend to continue.

### Non-Bank Financial Institutions

2.29 The intermediaries included in the NBFI category are money market corporations, finance companies, general financiers, pastoral finance companies, building societies and credit unions. The number of each of these types of intermediaries in operation and the size of their assets are detailed in Table 2.2.

6 McKinsey & Company Australia with the McKinsey Global Institute 1995.

## *The NBFI Sector Snapshot . . .*

### Table 2.2: Number and Assets of NBFIs in 1996

| ➢ | ➢ Number | ➢ Assets ($ billion) |
|---|---|---|
| ➢ Money market corporations | ➢ | ➢ |
| ➢ Finance companies | ➢ | ➢ |
| ➢ General financiers | ➢ | ➢ |
| ➢ Pastoral finance companies | ➢ | ➢ |
| ➢ Credit unions | ➢ | ➢ |
| ➢ Building societies | ➢ | ➢ |

Source: Department of the Treasury, Submission No. 143 to the Financial System Inquiry; *Reserve Bank of Australia Bulletin*, October 1996.

2.30 These organisations can be regarded as providing the same services as banks although each institutional grouping generally offers a narrower range of services than a full service bank. Some have business customers or operate in ‘wholesale’ activities — including money market corporations. Others are retail deposit-taking institutions — building societies and credit unions — operating 1,536 branches and 2,084 agencies as at June 1996.[7]

2.31 Together, NBFIs constitute approximately 15 per cent of the financial system (in terms of assets), compared with nearly 33 per cent in 1980. The fall is due mostly to reductions in the proportion of assets held by finance companies (14 per cent in 1980, down to 3.6 per cent in 1995) and permanent building societies (8.3 per cent down to 1.5 per cent).[8] These reductions are largely attributable to the conversion of some major building societies to banks and to bank acquisition activity.[9] In recent years, however, the asset growth of credit unions and the remaining building societies has strengthened.

7 Unpublished data obtained from the Australian Financial Institutions Commission.
8 Foster, R.A. 1996.
9 For example, NSW Building Society to Advance Bank and St George Building Society to St George Bank.

## Products

2.32 Payments and settlement services, credit and deposits are the main products and services provided by the deposit-taking sector. Each of these is examined in turn below, from a retail perspective.

### Payments

2.33 The deposit-taking sector provides a range of mechanisms for making retail payments. At the retail level, payments are made by a variety of mechanisms, most commonly cash, cheques and electronic methods, both directly and by use of cards (see Table 2.3). Overwhelmingly, the greatest number of consumer payments are made using cash.

## *The Broad Shape of Retail Payments Activity . . .*

Table 2.3: Number and Value of Different Payment Mechanisms

| Type of Transaction | No. per annum | Value per annum |
|---|---|---|
| Cash transactions | 18.0 billion | (not available) |
| Cheque transactions | 1.0 billion | $7,000 billion |
| Direct entry transactions | 0.5 billion | $250 billion |
| Credit/debit card - cash withdrawal | 0.5 billion | $40 billion |
| - other transactions | 0.4 billion | $55 billion |

Source: Mair, Peter 1995; Australian Payments Clearing Association, Submission No. 33 to the Financial System Inquiry; *Reserve Bank of Australia Bulletin*, October 1996.

2.34 Cheques continue to play an important role as a consumer payments medium. However, most of the growth in non-cash payments is in electronic methods. These include transaction cards, both credit and debit cards, with debit cards overtaking credit cards in usage. There has also been strong growth in direct entry electronic transfers, including OTC and telephone bill payment services. As these electronic services develop further, it is possible that the volume and total value of cheques will fall.[10]

2.35 Transaction cards are used both as instruments for making payments and as a means to access cash. Each day in Australia, transaction cards issued by banks are used for about 2.7 million cash withdrawal and payments transactions worth around $270 million (80 per cent of the value of retail trade). The average size of payments transactions is $100 for credit card purchases, $50 for debit card purchases and $140 for card-based cash withdrawals.[11]

2.36 While the number and usage of ATMs for standard withdrawals of cash and credit card payments have steadily increased, this growth has been overtaken by the growth in usage of EFTPOS terminals for payments. The growth in usage of EFTPOS over the past 4 years is illustrated in Table 2.4. The number of EFTPOS terminals and ATMs per million population is shown in Figure 2.5, which indicates the relative growth in these 2 most common forms of electronic transaction facility at the retail level.

## *Rapid Growth of EFTPOS . . .*

### Table 2.4: EFTPOS Terminals and Transactions in Australia

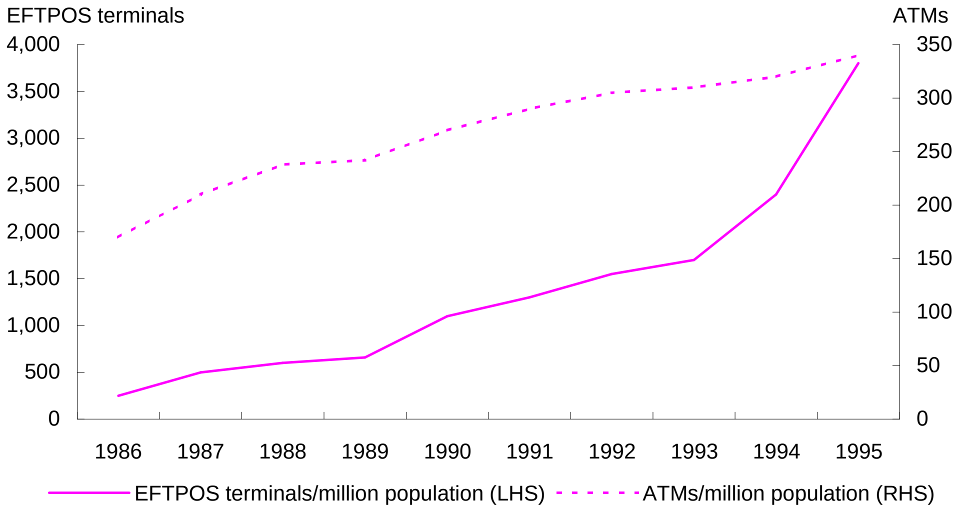
| | 1991-92 | 1992-93 | 1993-94 | 1994-95 | 1995-96 |
|---|---|---|---|---|---|
| Terminals (number at end of period) | 26,314 | 30,624 | 44,001 | 68,034 | 116,704 |
| Transactions (millions during period) | 129 | 188 | 245 | 340 | 470 |

Source: Australian Payments System Council 1996.

10 See *Reserve Bank of Australia Bulletin*, October 1996.

11 *Reserve Bank of Australia Bulletin*, October 1996. Figures are for August 1996, assuming transactions are averaged over 31 days. Comparable figures for non-bank issued cards are not available.

## Figure 2.5: Electronic Payment Methods




Source: Australian Payments System Council Annual Reports.

2.37 Stored value cards (SVCs) are a new payments technology whose adoption may become more widespread in the retail consumer market. In simple terms, they are electronic reloadable cards which substitute for cash. Existing credit and debit card issuers plan to extend the capability of their cards to include stored value capacities.[12] The immediate impact of these cards may be greatest in industries involving high-volume, low-value cash transactions (eg for public transport and tollways).

### Settlement Systems

2.38 Total gross non-cash payments flows in Australia are estimated at $90 billion per day[13], which represents a turnover of the nation's entire annual GDP about every 5 days. In comparison, the consolidated capital base of all Australian banks was just over $50 billion at the end of June 1995.[14]

12 Australian Payments System Council 1995.

13 Australian Payments Clearing Association, Submission No. 33 to the Financial System Inquiry, p.7.

14 *Reserve Bank of Australia Bulletin*, October 1996.

2.39 Non-cash payments (summarised in Table 2.5) are made up of the following distinct sub-systems.

- Cheques and other paper payment instructions.
- Direct entry systems.
- Credit cards (Bankcard, Visa, MasterCard) and debit cards in use at ATMs and in EFTPOS.
- Bank Interchange and Transfer System (BITS) — a real-time, high-value electronic system which provides, by agreement, irrevocable payment for amounts of $10,000 or more. It carries a large proportion of the Australian dollar transfer of foreign exchange settlements. BITS is jointly owned by the 4 major banks and the Colonial State Bank.
- Reserve Bank Information and Transfer System (RITS) — which provides registry, depository and trading facilities for Commonwealth Government securities and incorporates a delivery versus payment settlement facility for transfers of securities registered in the system. Members of RITS include all the banks and other major traders of Commonwealth Government securities. Non-bank members (other than credit unions and building societies) must have a member bank take responsibility for their payments.
- Austraclear — which provides registry, depository and trading facilities for private sector and semi-government securities. Austraclear is a public company formed in 1984 by leading participants in the Australian money market. It now has 500 participants.
  - Both RITS and Austraclear allow cash transfers unrelated to security trades.

## *Growth of Electronic Settlement Systems . . .*

Table 2.5: Payments Exchanged by Instrument

| **Payment instrument** | **Gross value per day ($billion)** | | | **Per cent of total** | | |
|---|---|---|---|---|---|---|
| | 1991 | 1993 | 1995 | 1991 | 1993 | 1995 |
| ***Paper (mainly cheques)*** | 30 | 25 | 27 | 59 | 36 | 35 |
| ***Electronic (Retail)*** | | | | | | |
| Direct entry | 1 | 1 | 1 | 2 | 1 | 1 |
| Plastic cards[15] | ** | ** | ** | # | # | # |
| ***Electronic (Wholesale)*** | | | | | | |
| BITS | 12 | 20 | 22 | 24 | 29 | 28 |
| Austraclear | 7 | 14 | 18 | 13 | 20 | 23 |
| RITS | 1 | 10 | 10 | 2 | 14 | 13 |
| **Total** | 51 | 70 | 78 | 100 | 100 | 100 |

** Less than half of $1 billion.
# Less than half of one per cent.

Source: Australian Payments Clearing Association, Submission No. 33 to the Financial System Inquiry.

2.40 Participation in the payments settlement system is determined by law, by the regulatory authorities and by industry self-regulation. The conditions governing entry and participation are quite different for each sub-system. Where participation is determined by industry self-regulation, conditions have been established by agreement among participants or are determined as a matter of bilateral negotiation.

### Credit

2.41 The deposit-taking sector is the main provider of retail credit products. The primary uses of such credit are for housing finance, overdrafts, personal loans and revolving credit (credit cards).

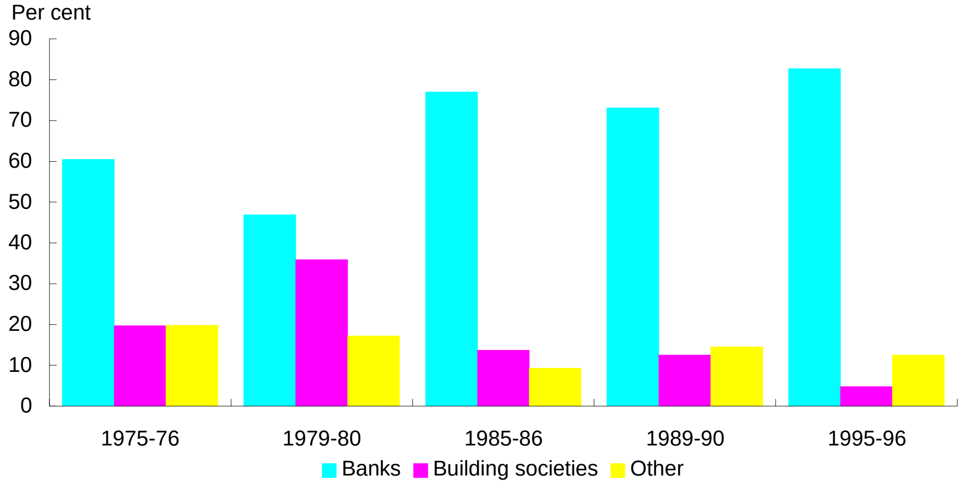
2.42 An indication of market share in the housing finance market over time is provided in Figure 2.6. The banks currently provide around 82 per cent of new household finance, with most of the remainder met by non-bank deposit-taking institutions. In recent times, mortgage originators

15 Includes debit and credit card transactions.

have begun to make major inroads into the housing finance market. At May 1996, they had 8 per cent of the new mortgage market compared to less than 1 per cent a decade ago.[16] The decline in the position of building societies is partly the result of some of the larger building societies converting to banks.

## *Banks are the Predominant Housing Finance Providers . . .*

Figure 2.6: Market Shares for New Housing Finance




Source: Australian Bureau of Statistics cat. no. 5609.0 1996.[17]

2.43 The market shares of various banking sector intermediaries for new personal fixed loan commitments[18] and revolving credit commitments[19] are

16 Australian Bureau of Statistics cat. no. 5609.0 1996; *Reserve Bank of Australia Bulletin*, June 1996, p.2.

17 The survey only includes significant lenders. The composition of the 'Other' category changes over time as smaller lenders fall out of the series (but still may provide some housing finance) and others become significant (such as the mortgage originators during the 1990s).

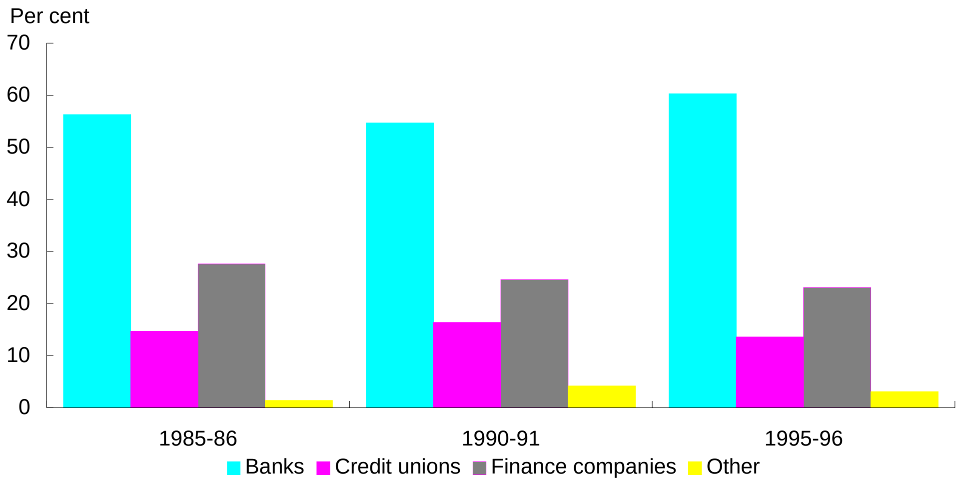
18 Generally a fixed amount for a fixed period for a specific purpose, with payments that reduce the loan amount without further finance being made available.

19 A credit or borrowing limit with drawdowns at the borrower's option.

illustrated in Figures 2.7 and 2.8. These shares have changed very little over the past 10 years, with banks maintaining the largest share in each case.

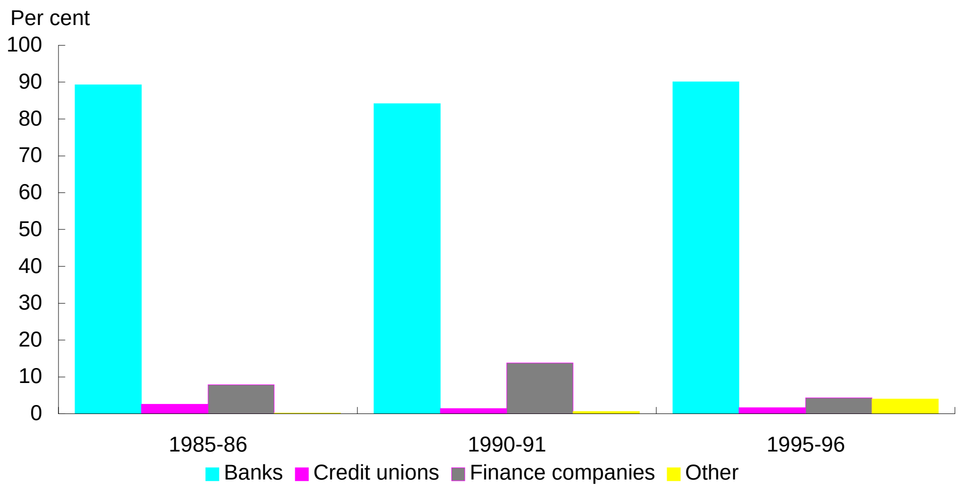
## *Banks Maintaining or Increasing Market Share of Other Forms of Credit . . .*

Figure 2.7: Market Shares for New Fixed Loan Commitments




Source: Australian Bureau of Statistics cat. no. 5642.0 1996.

Figure 2.8: Market Shares for New Revolving Credit Commitments




Source: Australian Bureau of Statistics cat. no. 5642.0 1996.

### Deposits

2.44 As with personal loans and revolving credit, the supply of deposit products has been dominated traditionally by banks (see Table 2.6). The decline in the share of building societies over the period 1981 to 1995 is largely attributable to the conversion of building societies to banks in the post-deregulation era.

## *Banks Hold the Majority of Deposits . . .*

Table 2.6: Percentage Share of Deposits: June 1981 and February 1995

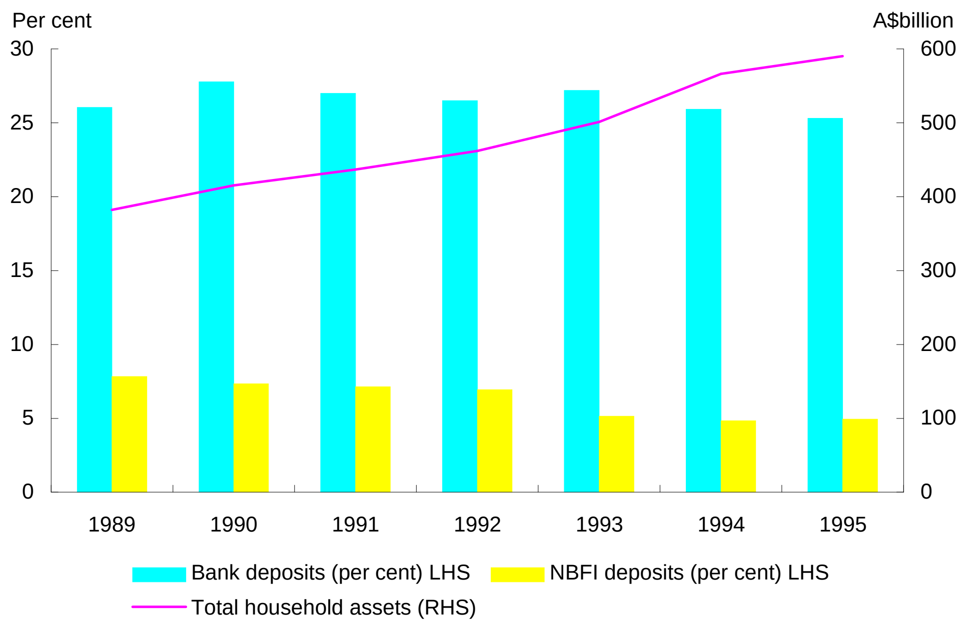
| | June 1981 | February 1995 |
|---|---|---|
| Banks | 74.0 | 79.6 |
| Building societies | 22.7 | 8.4 |
| Credit unions | 3.3 | 8.2 |
| Cash management trusts | -- | 3.8 |

Source: Prices Surveillance Authority 1995.

2.45 Deposits remain a large but declining proportion of total financial assets of the household sector (see Figure 2.9). Over the period 1989 to 1995, while total household financial assets increased from $382 billion to $590 billion, deposits fell from 33.9 per cent to 30.3 per cent of total household assets.

## *Deposits Declining as a Proportion of Household Sector Assets . . .*

Figure 2.9: Deposits Held by Banks and NBFIs as a Percentage of Total Household Assets




Source: Foster, R.A. 1996.

## Insurance, Superannuation and other Managed Funds Sector

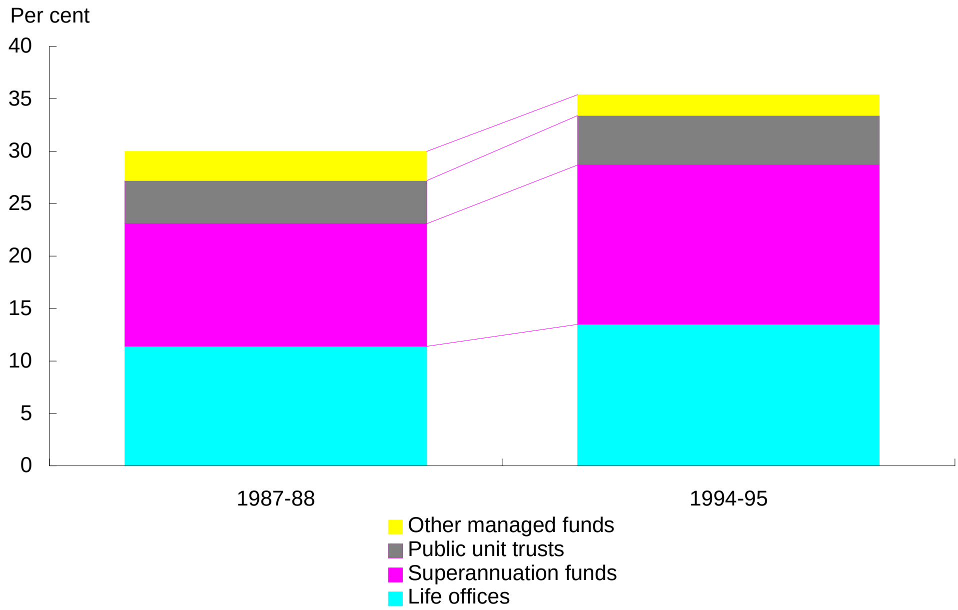
2.46 This sector comprises life offices, superannuation funds, general insurance companies, unit trusts and other collective investment schemes. The main outputs of this sector include investment products (including investment-linked life insurance products) and risk management products. The primary distribution channels include agency and independent sales forces, although a growing proportion of life insurance business is being written through bank branches.

2.47 Over the period 1988 to 1995, total funds under management increased from 48.8 per cent of GDP to 63.6 per cent of GDP. Expressed as a proportion of total financial system assets (excluding the RBA), total funds under management increased from 30 per cent in 1988 to 35.4 per cent in 1995 (see Figure 2.10).

2.48 An implication of the trend away from deposits toward managed funds is that customers are increasingly taking on risk in financial transactions.

## *Growth in Managed Funds . . .*

Figure 2.10: Managed Funds as a Percentage of Total Financial System Assets




Source: Foster, R.A. 1996.

## *Institutions*

### Life Offices

2.49 Life companies offer a range of products, including risk contracts, capital guaranteed and market-linked investment products and retirement pensions and annuities. A large and increasing share of the business of life offices comprises superannuation business, which is conducted at both wholesale and retail levels.

2.50 Until the early 1970s, mortgage loans (generally fixed interest) were also part of the product range of life offices. Their involvement in this market reflected (among other things) the inability of banks to satisfy market demand and also the relatively early stage of development of alternative mortgage providers. Life offices were able to link their loans with whole-of-life policies which benefited from generous tax treatment. Total direct lending by life offices has declined steadily from around 40 per cent of assets in the late 1950s to around 7 per cent at present.[20]

2.51 Until recently, large mutual life insurance companies held more than half of the industry's market share, but some of these have now demutualised or announced plans to do so. At December 1995, the 3 largest life insurance groups accounted for 52 per cent of the industry's Australian assets. The top 10 groups of companies account for about 80 per cent of industry assets.

2.52 In all, there were 51 registered life insurance companies in Australia as at 30 December 1995, with $124 billion or around 14 per cent of total financial sector assets. Superannuation business accounted for $91 billion in assets held in statutory funds (or about 70 per cent), while $33 billion was ordinary life insurance business.[21]

2.53 Bank-owned life offices have increased market share greatly in the past five years. Total life premiums sold through bank-owned life offices increased from 9 per cent in March 1991 to 24 per cent in March 1996. Bank-owned life offices now account for 37 per cent of all single-premium life business (eg term insurance) but only 4 per cent of annual-premium business.[22] Banks have been able to obtain this share by utilising their existing branch networks as the major distribution mechanism.

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20 Edey, Malcolm & Gray, Brian 1996.

21 Insurance and Superannuation Commission, Submission No. 53 to the Financial System Inquiry, p.33.

22 Unpublished data obtained fron the Insurance and Superannuation Commission, sourced from the *Quarterly Statistical Bulletin.*

### Superannuation Funds

2.54 In June 1996, there were around 140,000 superannuation funds registered in Australia. Most of these (130,000) are very small self-managed or 'do-it-yourself' funds with fewer than 5 beneficiaries. The largest 1 per cent of funds represent 85 per cent of the superannuation industry's total assets. These funds are larger employer-sponsored, public sector, industry or public offer funds.[23]

2.55 Superannuation funds are invested in domestic and off-shore assets (shares, property, bonds, cash, etc) to diversify risk and to achieve an adequate return for investors. As at June 1996, the value of total assets in the superannuation system was $248 billion. Of these funds, $82 billion is placed with investment managers, $93 billion is invested in life office statutory funds, and $73 billion is invested directly by the funds.[24] Table 2.7 indicates that life office superannuation funds hold the largest share of total assets, but this share has been declining at a rate of around 1 per cent per year. In June 1992, life offices held 44 per cent of total superannuation assets.[25]

## *Life Offices Losing Superannuation Share . . .*

Table 2.7: Superannuation Assets by Manner of Investment, 1995-1996

| **Manner of Investment** | **June 1995** | | **June 1996** | |
|---|---|---|---|---|
| | $ million | Per cent of total | $ million | Per cent of total |
| Directly Invested | 62,967 | 28.2 | 73,353 | 29.5 |
| Placed with an Investment Manager | 74,143 | 33.2 | 82,123 | 33.0 |
| Invested in Life Office statutory funds | 86,056 | 38.6 | 93,272 | 37.5 |
| **Total** | 22,3166 | 100.0 | 248,748 | 100.0 |

Source: *Insurance and Superannuation Commission Bulletin*, June 1996.

23 *Insurance and Superannuation Commission Annual Report 1995-96*, pp.74-75.
24 *Insurance and Superannuation Commission Bulletin*, June Quarter 1996, Table 1.
25 *Insurance and Superannuation Commission Bulletin*, June Quarter 1996, p.31.

### General Insurance

2.56 The term general insurance encompasses both direct underwriters and reinsurers writing risks such as property, injury, compulsory third-party insurance and workers' compensation, but does not include health insurance. Some remain in public ownership. In total, there are 177 general insurance companies, with total assets of about $55 billion. The longer-term trend evident since the 1970s is for fewer institutions, as low returns on capital have encouraged mergers and rationalisations within the industry.[26] In recent times, most of the State Government-owned insurance companies have been privatised.

### Other Managed Funds (excluding Insurance and Superannuation)

2.57 As at June 1995, approximately $63 billion of managed funds existed outside the insurance and superannuation sectors. This sector comprises over 420 public unit trusts ($41 billion assets), over 200 friendly societies ($9 billion assets), 14 common funds ($4 billion assets) and 20 cash management trusts ($6 billion assets).[27]

2.58 Public unit trusts have experienced major growth during the 1990s. Between June 1990, when the assets of public unit trusts stood at $27.7 billion, and June 1995, the assets of this segment increased by some 49 per cent. This compares favourably with increases of 6 per cent by friendly societies and 20 per cent by cash management trusts.[28]

## *Products*

### Retail Investment and Retirement Products

2.59 Several trends have emerged in markets for retail investment and retirement products, generally driven by taxation and regulatory changes. One notable trend, and one which is likely to continue, is the huge growth in

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26 *Insurance and Superannuation Commission Annual Report 1994-95*, p.31.
27 Insurance and Superannuation Commission, Submission No. 53 to the Financial System Inquiry, Appendix A; and Foster, R.A. 1996.
28 Foster, R.A. 1996.

superannuation, driven largely by a Government social objective to increase private saving through various measures, including tax concessions. The stock of superannuation assets is growing at twice the rate of growth in the economy. Superannuation assets are expected to grow from $240 billion now to around $500 billion (in real terms) by the year 2005.[29]

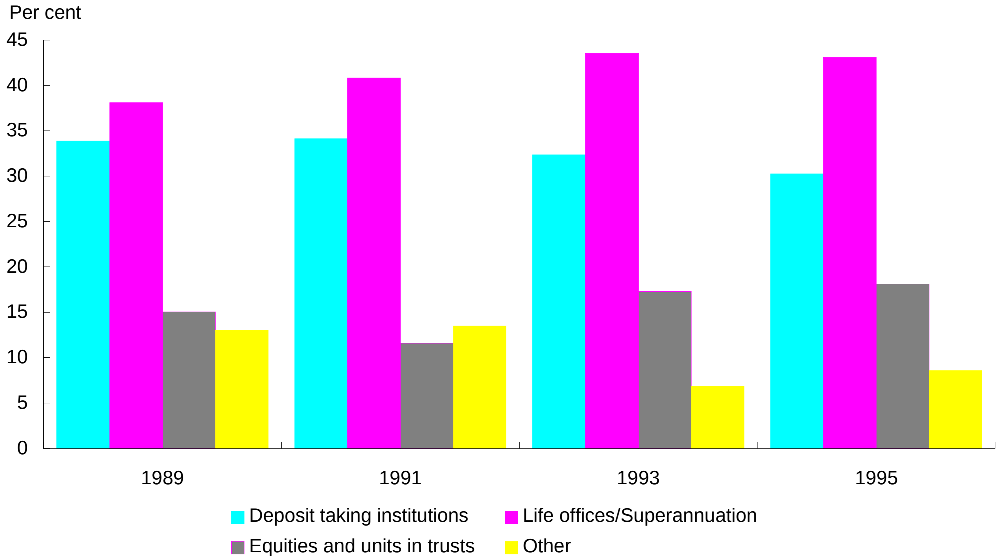
2.60 This trend is reflected in changes in the composition of household assets over the period 1989 to 1995 (see Figure 2.11). Life office and superannuation products rose from 38.1 per cent in 1989 to 43.1 per cent of total household sector assets in 1995, primarily because of the growth in the superannuation segment, while holdings of deposit-taking institutions fell from 33.9 per cent to 30.3 per cent over the same period. Most of the growth in superannuation assets is attributable to variations in the earnings and capital gains of superannuation assets rather than to increased contributions.[30]

2.61 In addition, there is some substitution of superannuation products for the short-term saving products of deposit-taking institutions, as the superannuation sector has become a major holder of the short-term savings of retirees. Increasing rates of early retirement, the wide availability of lump-sum retirement benefits and the advent of rollover funds have encouraged this.[31]

29 Allen Consulting Group 1996, p.38.
30 Edey, Malcolm & Gray, Brian 1996.
31 Edey, Malcolm & Gray, Brian 1996.

## *Growth of Superannuation Funds . . .*

Figure 2.11: Household Assets by Category (percentage of total)




Source: Foster, R.A. 1996.

2.62 Equities and units in trust also increased as a proportion of household assets from 15 per cent to 18 per cent over the period 1989 to 1995. The introduction of dividend imputation in 1986 as well as the favourable tax treatment of unit trusts is likely to have encouraged this trend. As with some superannuation products, unit trust products are increasingly offering a range of short-term investment services, some of which closely resemble deposits.[32]

2.63 A major change in the types of products offered by life offices has been the growth in market-linked insurance products (investment-type products) relative to non-market-linked products (risk products, annuities and endowments). Over the period 1990 to 1995, the market-linked assets of life offices increased by 134 per cent, with the majority of this growth occurring in their superannuation business. In contrast, the

32 Edey, Malcolm & Gray, Brian 1996.

non-market-linked assets of life offices increased by only 4 per cent over the same period, with those assets relating to the ordinary business falling by about 6 per cent.

### Risk-Related Products

2.64 At the retail level, the primary suppliers of risk-related products are life and general insurance companies.

2.65 The types of policy written by life companies has undergone considerable change. In the past 10 years, there has been a shift towards ‘unbundling’ of products. Thus, as shown in Table 2.8, traditional products (such as whole of life cover) have declined in favour of single-premium products (such as term life, trauma and disability cover) and separate pure investment products.[33] This likely reflects improved commission disclosure and a greater level of consumer awareness of alternative avenues for investment. Premium rates have been driven down — today the premium rate for insuring a 35-year-old male in good health is 40 per cent lower than the rate charged in 1992 .[34]

## *Traditional Life Policies Losing Market Share Rapidly . . .*

Table 2.8: New Annual Premiums Paid to Life Companies, by Product ($ million)

| Product | Sept 1985 | Sept 1990 | Sept 1995 |
|---|---|---|---|
| Term Life | 49.9 | 100.3 | 175.1 |
| Disability | 26.4 | 67.1 | 136.0 |
| Traditional (Whole of life, Endowment) | 110.7 | 441.6 | 38.5 |

Source: Life, Investment and Superannuation Association 1996.

2.66 The products offered by general insurance companies have not changed greatly. In 1995, total assets of private sector general insurance

33 Life, Investment and Superannuation Association of Australia 1996.
34 Jonson, Peter 1996.

companies stood at $34.1 billion, with another $19.2 billion in public sector insurers (compared to $21.4 billion in 1992).[35] Premium income stood at $12.2 billion ($7.8 billion in 1992) for private sector insurers, the bulk (nearly 40 per cent) provided by motor vehicle and domestic household insurance.

2.67 Trends in premium income over the period 1992 to 1995 for selected general insurance products are presented in Table 2.9. Premium income for employers' liability and product liability insurance, and also for travel insurance, increased dramatically over this period.

## *Employers' Liability, Product Liability and Travel Insurance have been the Growth Areas in General Insurance . . .*

Table 2.9: Selected General Insurance Premium Trends ($ million)

| Class of Business | 1992 | 1995 | Percentage change |
|---|---|---|---|
| Motor vehicle | 2,512 | 3,572 | 42.2 |
| Houseowners/householders | 1,260 | 1,977 | 56.9 |
| Employers' liability | 244 | 1,234 | 405.7 |
| CTP motor vehicle | 837 | 1,089 | 30.1 |
| Public liability | 450 | 699 | 55.3 |
| Fire | 527 | 546 | 3.6 |
| Professional indemnity | 253 | 407 | 60.9 |
| Sickness and accident | 184 | 231 | 25.5 |
| Travel | 87 | 160 | 83.9 |
| Consumer credit | 104 | 137 | 31.7 |
| Product liability | 48 | 102 | 112.5 |
| Loan, mortgage and lease | 53 | 70 | 32.1 |

Source: Insurance and Superannuation Commission 1995, *Selected Statistics on the General Insurance Industry*.

2.68 The increase in employers' liability reflects the movement of business from the public sector to the private sector due to the privatisation

35 *Insurance and Superannuation Commission Annual Reports 1991-92, 1994-95,* and *1995-96.*

of Government Insurance Offices (GIOs) New South Wales and Victorian employers' liability arrangements in 1992.[36] The observed growth in product liability insurance coincided with the introduction in 1992 of a more stringent product liability regime under the *Trade Practices Act 1974*. Travel insurance has traditionally generated relatively large premium income for general insurance companies.

## Distribution

2.69 Until recently, the primary distribution channel for life offices has been the 'tied' agency sales force. However, in recent years, the number of agents has decreased, as insurers have sought to consolidate their agency relationships and seek alternative distribution methods. The Life Insurance Marketing and Research Association estimates that the number of agents declined from 20,000 in 1988 to around 5,000 by 1995. Around half of new business written by life offices is now distributed through investment advisers and securities dealers, multi-agents (ie agents for more than one company) and bank branches (which operate as distribution channels for the banks' subsidiary life offices).[37] In many cases, new life business is being generated through packaging with superannuation products.

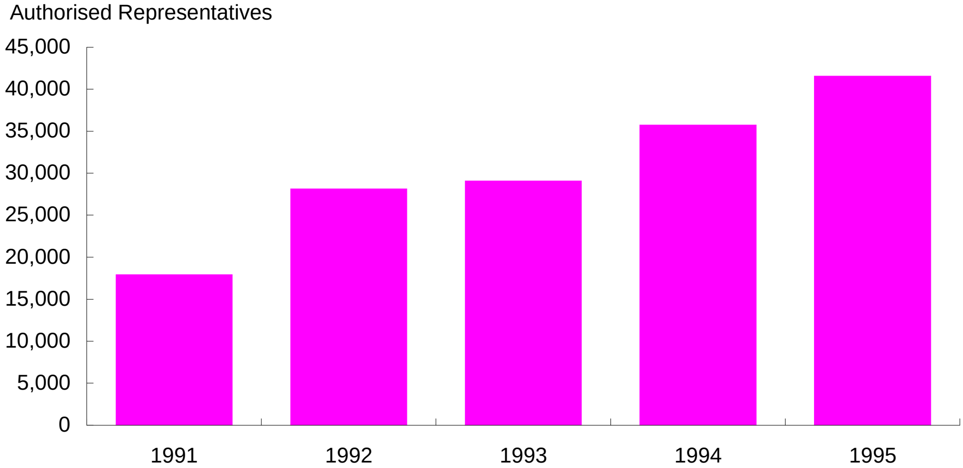
2.70 While the number of life agents has been declining, the number of authorised representatives of securities dealers and of investment advisers has increased. The number of authorised representatives increased from 17,914 at 30 June 1991 to 41,471 at 30 June 1995 (see Figure 2.12). Conversely, the number of licensed securities dealers and investment advisers fell marginally over the same period, from 1,803 to 1,640.

36 *Insurance and Superannuation Commission Annual Reports 1991-92, 1994-95,* and *1995-96.*

37 Insurance and Superannuation Commission, Submission No. 53 to the Financial System Inquiry, p.35.

***Growth in Investment Advice Industry . . .***

Figure 2.12: Number of Authorised Representatives of Securities Dealers and Investment Advisers




Source: *Australian Securities Commission Annual Reports*, 1994 & 1995.

# Financial Markets

## Overview — Relative Size of Australian Financial Markets

2.71 The majority of financial transactions are channelled through the Australian financial markets, including the markets for equities, debt, foreign exchange and derivatives. The average daily turnover of the Australian financial markets in recent years is shown in Table 2.10. In 1994-95, total average daily turnover in Australian financial markets was equivalent to around 18 per cent of annual GDP, with the foreign exchange market accounting for around 60 per cent of the total.

2.72 Since the beginning of the 1980s, there has been a gradual shift from multilateral, or on-exchange, markets towards bilateral, or OTC markets. OTC markets have developed greatly since 1981, when the Final Report of the Campbell Committee was released. At that time, OTC products were limited to bills of exchange, cash, fixed interest (bonds), and a regulated foreign exchange market. According to the Australian Financial Markets Association submission, 'all these areas were in phases of early development and received small consideration in the Committee's deliberations'.[38] The OTC markets are now the largest single group of markets in the Australian financial system.

### *OTC Markets Form the Largest Grouping of Australian Financial Markets . . .*

Table 2.10: Average Daily Turnover in Australian OTC and On-Exchange Markets ($ billion)

| | 1992-93 | 1993-94 | 1994-95 |
|---|---|---|---|
| ***OTC markets:*** | | | |
| Foreign exchange | 47.1 | 50.8 | 50.7 |
| Government bonds | 3.0 | 4.1 | 5.9 |
| Bank bills and CDs | 1.7 | 1.5 | 1.6 |
| ***On-exchange markets:*** | | | |
| SFE bank bill futures | 12.2 | 15.8 | 19.0 |
| SFE Govt bond futures | 4.4 | 5.9 | 6.0 |
| ASX | 0.3 | 0.5 | 0.5 |
| SFE equity futures | 0.3 | 0.6 | 0.4 |

Source: Foster, R.A. 1996.

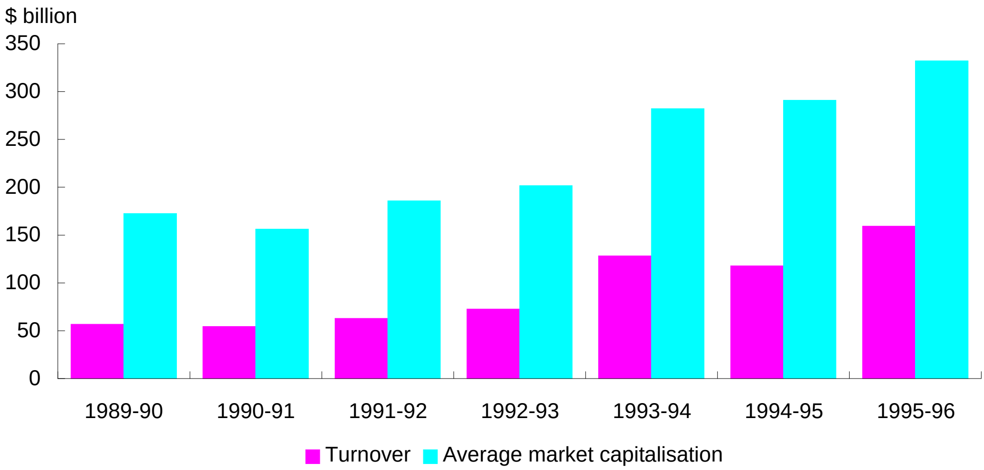
## Equities Market

2.73 About 1,200 companies are listed on the Australian Stock Exchange (ASX), while most of the top 50 companies are also listed on one or more foreign exchanges. As illustrated in Figure 2.13, turnover has nearly tripled and market capitalisation doubled on the ASX since 1989-90.

38 Australian Financial Markets Association, Submission No. 129 to the Financial System Inquiry, p.7.

## *Growth of the ASX . . .*

Figure 2.13: Turnover and Market Capitalisation on the ASX




Source: Securities Industry Research Centre of Asia-Pacific 1996.

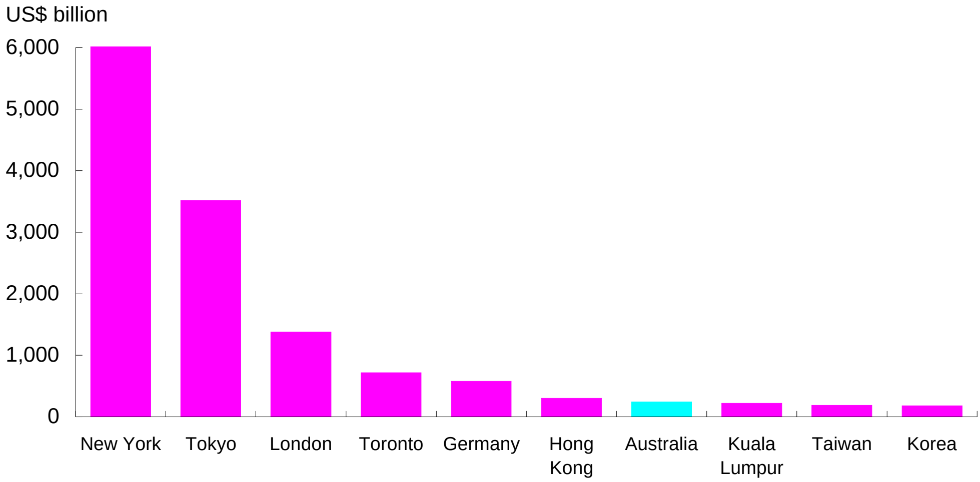
2.74 As at June 1996, market capitalisation of listed domestic equities stood at around $347 billion, compared to $299 billion one year earlier and $198 billion in June 1992.[39] This very large growth in market capitalisation has been boosted by a number of significant privatisations at both Commonwealth and State Government levels, the most significant of which (Qantas, the Commonwealth Bank of Australia, TabCorp, Commonwealth Serum Laboratories and various Government Insurance Offices) represent about one quarter of the capital raised in new floats over that period.[40]

2.75 The ASX currently ranks tenth in the world in domestic market capitalisation.[41] Market capitalisation of several world stock exchanges in 1995 is illustrated in Figure 2.14.

39 *Reserve Bank of Australia Bulletin*, July 1996.
40 Allen Consulting Group 1996, p.11.
41 Australian Stock Exchange, Submission No. 65 to the Financial System Inquiry, p.7.

## *ASX is Small in Global Terms . . .*

Figure 2.14: Market Capitalisation of Selected Stock Exchanges 1995




Source: Securities Industry Research Centre of Asia-Pacific 1996.

## Debt or 'Bond' Markets

2.76 The debt or bond markets include the markets for short-term bank securities (such as bank bills), Treasury notes, and State Government and private commercial paper. The markets for long-term securities tend to be dominated by government bonds, but also include mortgage-backed securities and corporate bonds. The size of the Australian bond market in 1994 was estimated at US$88 billion (around $120 billion).[42]

42 Allen Consulting Group & Arthur Andersen 1996, p.56. The Australian dollar equivalent was calculated using the end June 1994 exchange rate.

2.77 As in all major bond markets, government debt securities form the largest and most liquid segment of the Australian bond market. As at December 1995, Commonwealth Government securities on issue had an outstanding value of $113.2 billion, and State and local government debt an outstanding value of $93.5 billion.[43] Consistent with changes in the home lending market, securitised mortgages appear to be an emerging segment of the debt markets.

2.78 The corporate debt market, on the other hand, is relatively undeveloped. The Allen Consulting Group has observed that ‘it is not at present worthwhile for a corporate to undertake a major public debt issue in Australia, and the overheads involved, and the need to establish significant depth and liquidity quickly, present formidable challenges to the development of a major corporate debt market here’.[44]

2.79 The major holders of debt securities are financial institutions such as banks, insurance companies and the funds management industry. The major traders of debt securities in Australia are commercial banks, authorised bond dealers and money market corporations.

## Derivatives Markets

2.80 Derivatives trading in Australia includes trading on OTC markets or on-exchange.

- OTC derivatives are flexible and can be customised to meet each party’s specific needs, though at the cost of higher counterparty and operational risks and lower liquidity. Legal risks on OTC markets are usually reduced by the use of International Swaps and Derivatives Association or similar standardised documentation.
- Exchange traded derivatives provide standardised terms, guaranteed settlement, and novation. These characteristics help generate market liquidity. The markets in Australia comprise the

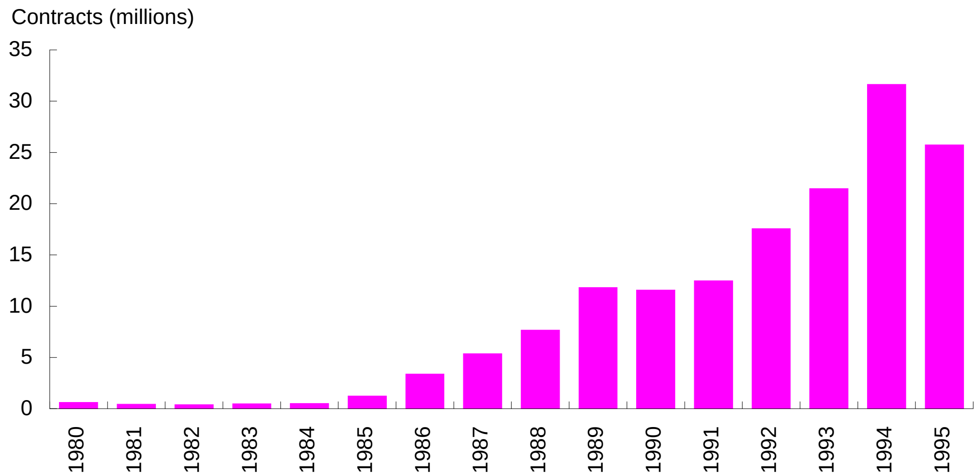
43 Australian Bureau of Statistics cat. no. 5232.0 1996.
44 Allen Consulting Group 1996, p.6.

Sydney Futures Exchange (SFE) and the options market conducted by the ASX.

2.81 The SFE provides a market for 2 types of derivatives — futures and options. The SFE is the thirteenth largest futures market in the world, with annual turnover in 1995 of a nominal value of $6.8 trillion on 25.7 million contracts.[45] Figure 2.15 shows the growth in the number of contracts traded on the SFE since 1980.

## *Growth of SFE Trading . . .*

Figure 2.15: Sydney Futures Exchange Annual Trading Volumes




Source: *Sydney Futures Exchange Yearbook* 1995.

2.82 On-exchange and OTC derivatives markets are not totally independent markets as participants in the OTC market may utilise the liquidity of trading on-exchange to reduce their derivatives risks.

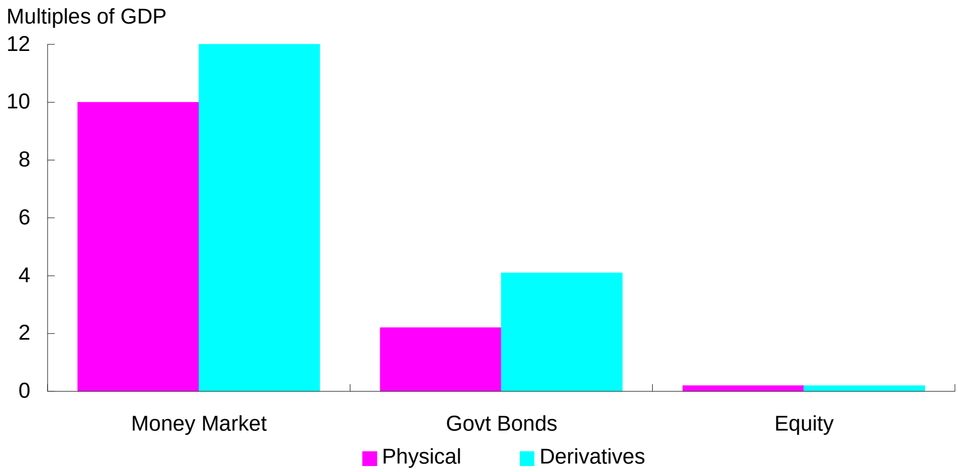
2.83 Trading on derivatives markets has typically exceeded trading on the underlying physical markets in terms of the volume and value of trades (see Figure 2.16). The main advantage of derivatives over physical asset

45 Sydney Futures Exchange 1995, p.56.

trading is that derivatives can be traded at lower cost and with a smaller initial outlay.[46]

## *Derivatives Trading Exceeds Underlying Physical Trading . . .*

Figure 2.16: 1994 Annual Turnover in Derivatives and Underlying Physical Markets as a Multiple of GDP




Source: International Banks and Securities Association of Australia, Submission No.146 to the Financial System Inquiry.[47]

2.84 This chapter has presented a snapshot of the Australian financial system, from an institutional and market perspective. The system is undergoing significant change, in both the nature of the business of institutions and the products delivered. Chapter 3 discusses the forces driving further change and their implications.

46 Department of the Treasury, Submission No. 143 to the Financial System Inquiry, p.31.

47 Note: Data cover both exchange traded and OTC derivatives, except for equities (futures only), and the underlying physical market. Money market physical turnover is estimated (see Lynch, D. 1995).