2. Types of Financial Institutions

Contents

2.1 Australian Financial Institution Types: Information Sources

There is a wide range of different types of financial institutions operating in Australia. While banks (ADIs), superannuation and other managed funds (unit trusts) and insurance (life and general) funds are the most well known, there are many other types. A list, provided by the RBA, giving current information about size, numbers of institutions, and types of activities is available here, and summarized in Table 1

Data about prescribed types of institutions began to be collected in 1974 (under provisions of the *Financial Corporations Act,* and since 1982 has been collected under the provisions of the Financial Sector (Collection of Data) Act 2001. A list of such *Registered Financial Corporations* is provided by APRA here. One difficulty with such *institutional type* listings is that new types of business models which do not fit neatly into existing categories, keep emerging, particularly with the FinTech revolution currently underway. The Australian Bureau of Statistics (ABS) also produces some statistics about the finance sector. Currently this information includes publications relating to: Lending Finance; Securitisation; Managed Funds; Venture Capital and Private Equity.

TABLE 1:FINANCIAL INSTITUTIONS AT DECEMBER 2021: NUMBER AND TOTAL ASSETS

Type of Institution	Number of Institutions	Total Assets ($ Bill)
Banks	96	5531.3 [a]
Credit Unions & Building Societies	36	50.6
Money Market Corporations	5	29.3
Finance Companies	102	295.5
Securitisers	- [b]	160.6
Life Insurance Companies	27	93.4
General Insurance Companies	93	250.3
Health Insurance Companies	34	17.9
Superannuation Funds	1651	3011
Public Unit Trusts	- [c]	449.3
Cash Management Trusts	- [d]	33.2
Common Funds	- [d]	10.3
Friendly Societies	11	7.5

Source: RBA.

(a) Includes only assets of domestic operations: (b) number not provided by RBA but in the region of 20-30: (c) number not provided by RBA but in the many hundreds and changes frequently; (d) number not provided by RBA but quite small

In 2019 APRA began collecting and reporting information about ADIs and RFCs under its new Economic and Financial Statistics (EFS) collection.

In the following sections, major types of Australian financial institutions are briefly described. Others are considered in subsequent chapters.

2.2 Banks and ADIs

In Australia, the term Authorised Deposit-Taking Institution (ADI) was introduced in 1998 to cover banks, credit unions and building societies, and distinguish between banks and the others, even though all undertake “banking business”. It was then, and is more so now, an unhelpful label – confusing and not found elsewhere internationally, particularly now that credit unions and building societies can call themselves “mutual banks”. (More detail on the institutions can be found in Chapter 6-1).

Banks are typically thought of as institutions which primarily

- take deposits and make loans
- provide payments services

Generally they are engaged in a wider range of activities (including wealth management, trustee services, insurance, advice, trading and market making, investment banking, and off-balance sheet

(OBS) activities), although Australian banks have recently divested themselves of some of these activities. The balance sheet funding of banks will generally involve a range of debt and hybrid securities as well as deposits and equity.

There are a variety of (often complex) organizational structures found internationally. In the USA, many banks are subsidiaries of a non-operating holding company which may control multiple banks, and raises equity and debt and allocates it to the bank. In some other countries, such as Australia, it is more common for the bank to be an independent entity, with its own equity base raised from shareholders and raising debt etc in its own name, and allocating capital to subsidiaries, which may include differently named banks operating domestically or internationally. In Australia, Macquarie, Suncorp, AMP are holding company structures (and ANZ converting to such a structure in early 2023), with a bank as one subsidiary and other activities (funds management, insurance etc.) conducted in other subsidiaries

In many countries there will be some form of ownership restrictions. In some cases this reflects long-standing concerns about the separation of banking and commerce (which also is reflected in restrictions on banks having significant equity interests in non-financial companies). In other cases it reflects concerns about concentrated ownership and control of banks by particular parties and takes the form of ownership diversification requirements or maximum ownership limits. (In the USA, small banks have often been owned by individuals or families).

In Australia, the Financial Sector (Shareholdings) Act 1998 specifies that there is a 20 per cent maximum shareholding limit (except with the Treasurer's permission) for ADIs and insurance companies.

The Australian Banking sector is relatively concentrated, but this is common internationally, with the USA (and China) being significant exceptions.[1] (See here for a (now somewhat dated) discussion, and note that while banks in the EU will be headquartered in one member country, they increasingly operate across all member countries – making country based concentration statistics less meaningful). The four-pillars policy (see Chapter 6) limits the extent to which concentration might be increased by preventing mergers between the four large major Australian banks and has been criticised by many such as the Productivity Commission, but supported by others. (The four-pillars policy does not prevent takeover of a major bank by a foreign bank).

[1] Relbanks website provides lists of largest banks in many countries, and worldwide (using various measures of size) and an indication of concentration can be gained by looking at the size of the largest 4 or 5 banks compared to the smaller ones listed.

Building Societies (Savings & Loans) and Credit Unions (many now called Mutual Banks) are examples of mutual or cooperative institutions, which are owned by their customer members and are "not-for-profit" entities. (However, some building societies were initially organised as joint-stock companies, and many others demutualised in the latter years of the twentieth century). They generally undertake a more limited range of activities (raising deposits, making loans, providing payments services) to individuals (and small businesses). In the early 1950s there were around 700 Australian credit unions (mostly very small), but declining numbers due to mergers mean there are now less than 50. Similarly Building Society numbers fell from around 30 in early 1990s to 3 in 2018.[2] (Similar experience has occurred internationally, particularly in the USA following the S&L Crisis in the late 1980s-early 1990s when around 1,000 of 3,000 S&Ls failed! The FDIC has a comprehensive website with information). Worldwide, there around 85,000 credit unions with 274 million members (WOCCU provides information).

One innovation has been the conversion of some smaller credit unions into, effectively, franchisees of Bendigo and Adelaide Bank, similar to its Community Bank model (see Chapter 5). In 2015, four credit unions became part of an Alliance Bank network, involving transferring loans and deposits to Bendigo but retaining ownership of members reserves, operating under Bendigo's banking licence, and providing the operational activities (under an Alliance Bank trading name). Details can be found here. A major factor driving this change was that the costly ADI regulatory and compliance requirements were now undertaken by Bendigo. "Profits" of the Alliance members could be used to support social and community activities – consistent with the spirit of the mutual model.

Banks and ADIs are subject to prudential regulation to protect depositors and avoid systemic instability. In Australia this is undertaken (since 1998) by APRA, a specialised prudential supervisor, which also supervises life and general Insurance companies, institutional superannuation funds, friendly societies, and health insurers. Internationally, there is a range of structures for regulation with prudential regulation sometimes being the responsibility of the Central Bank. See Masciandaro and Romelli (SSRN 2018) for an analysis of allocation of prudential regulation responsibilities worldwide.

Whereas government owned banks were once a significant part of the banking system, there are no longer any Federal or State government owned banks. At the start of the 1990s, several State government owned banks effectively failed (although no depositors suffered losses) and these were taken over by the other banks. The Commonwealth Bank was privatised by the Federal Government

[2] Increasing use of the designation as "Mutual Banks" means the current official ADI statistics on credit unions and building societies understate the number of entities which have their origins in those sectors.

in a staged process beginning in 1991 and completed in 1996 which Quiggin (2001) describes and criticises.

There had been no new banks registered in Australia between 1945 and the early 1980s, with the first of many entrants in the 1980s being the Australian Bank in 1981 (which was subsequently acquired by the State Bank of Victoria in 1989). Smaller Australian banks have evolved since 1981, many of which were former building societies. Information about the changing nature of the Australian banking sector between 1980 and 1990 can be found here. In recent years APRA has allowed mutual ADIs to rebrand as banks and provided new licenses (including restricted licenses) to new entrants (eg Xinja (since closed), 86400 (acquired by NAB), Volt (since closed), and Judo Bank). In August 2021, APRA released a document outlining its new approach to bank licensing, including stronger requirements for development of both deposit products and loan products for restricted licence holders. APRA maintains a register of current ADI license holders. In 2021 some consolidation occurred: Citigroup announced a sale of its Australian consumer banking business to NAB which was completed on June 1, 2022; Bank of Queensland announced an agreed acquisition of Members Equity Bank (completed on July 1, 2021); Xinja bank relinquished its restricted licence and NAB announced acquisition of *64 800.* In July 2022 ANZ announced that it was purchasing the banking operations of Suncorp.

Foreign owned banks' subsidiaries have been allowed entry to the Australian market since 1984, (although three long-standing foreign banks existed prior to that) and foreign bank branches have increased in numbers. There are restrictions on foreign branch retail banking activities and different supervision arrangements. (International practice is for branches of foreign banks to be supervised by their parent's home country supervisor). Cull et al from the World Bank provide a recent survey of literature on relative performance of foreign and government owned banks from an international perspective.

Banking is currently undergoing substantial changes reflecting the impact of "fintech" and the ability, created by digital technology, of other non-bank entities to provide some types of banking services. Banking as a Service (BaaS) is a term used to describe situations where a commercial business enables its customers to access, through its website, banking services (eg making deposits and payments) ultimately provided by a registered bank. For the bank, the benefit lies in accessing a possibly new range of customers who have a relationship with the commercial business, while the latter may attract more, or retain, customers by the expanded range of offerings. While the commercial business "white labels" the banking services offered by the bank (ie provides them under its own name) it essentially only acts as a conduit in linking the customer with the bank who holds the customers' deposits and provides the payment services.

2.3 "Shadow" Banking

This term has become popular to refer to non-prudentially regulated credit providers, and institutions which undertake credit, maturity, and liquidity transformation. It was defined by the Financial Stability Board as "credit intermediation involving entities and activities (fully or partially) outside the regular banking system". But in October 2018 the FSB announced it would "replace the term "shadow banking" with the term "non-bank financial intermediation" in future communications", partly because the former term carried a pejorative association. The FSB regularly monitors the sector, looking at three levels – the broadest encompassing all non bank intermediaries (including for example equity funds), a narrower set of, generally non-prudentially regulated, financial intermediaries, and a narrower set of NBFIs (OFIs) whose activities involve credit intermediation activities possibly generating bank-like financial stability risks and/or regulatory arbitrage.

Figure 1 shows the FSB depiction of the composition of financial systems in a range of advanced economies (AEs) and emerging economies (EMEs). For Australia (represented by AU) the size of OFI assets as a proportion of GDP (shown as the diamond) is significantly below some other countries (such as UK, Canada, China, USA) but similar to many other advanced economies.

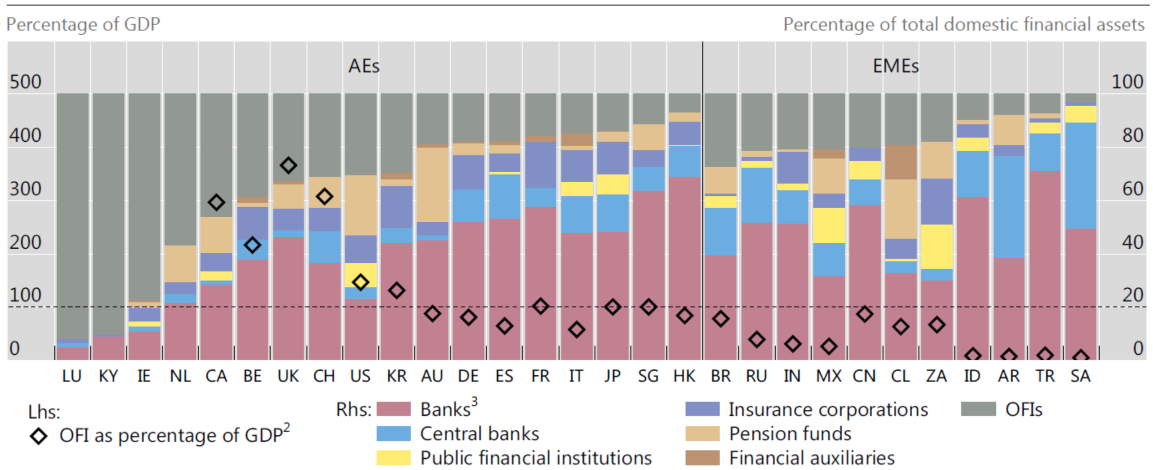

FIGURE 1: SHADOW BANKING AROUND THE WORLD

The FSB focuses on five types of entities in that last narrow group (OFIs) based on their classification of relevant economic functions:

- Collective Investment Vehicles (by far the largest sector) which have features making them susceptible to runs
  - MMFs, fixed income funds, mixed funds, credit hedge funds, real estate funds
- NBFIs engaged in loan provision and dependent on short term funding

  - Finance companies, leasing/factoring companies, consumer credit companies
- Market intermediaries that depend on short-term funding or secured funding of client assets
  - Investment banks, Broker-dealers, Securities finance companies
- Entities engaged in facilitation of credit creation
  - Merchant banks, Credit insurance companies, financial guarantors, monolines
- Entities engaged in securitisation-based credit intermediation.
  - Securitisation vehicles, structured finance vehicles, asset backed securities

The entities involved, such as Investment Banks often have activities beyond being alternatives to bank financing.

2.4 Investment banks/Securities Firms/Stockbrokers

These entities are engaged *inter alia* in

- fund raising (debt, equity) for clients; financial innovation; underwriting
- Property investments; venture capital; bridging finance (merchant banking)
- Brokerage and Trading
- Securities transactions for clients, own account trading;
- Other financial services: Asset management accounts, funds management, advisory services, prime brokerage

Nowadays, they are often part of large financial conglomerates including banks, but historically were often partnerships. (Morrison and Wilhelm, 2007) discuss reasons (such as increased need for equity capital and reduced significance of personal networks in generation of firm profits) behind the shift from partnership to joint stock form in the 1970s and the increase in risk taking resulting which has been seen by some as one of the factors causing the GFC.

Historical (and current) examples (have) included names such as:

- USA: Merrill Lynch, Goldman Sachs, Shearson Lehman Hutton, Salomon Smith Barney, Paine Webber, Morgan Stanley
- Australia: J.B. Were, Macquarie Bank

Compared to Banks, they are not prudentially regulated (although commercial banking activities conducted under a banking licence will be), but are regulated by securities regulators such as the SEC in the USA or ASIC in Australia. Note that in Australia, organisations which are not part of a Bank or ADI are not permitted by legislation to use the term "Investment Bank" as part of the restrictions on the use of the term "bank". Among the restrictions they face on activities are:

- A requirement to segregate customer funds from the firms' own funds
- liabilities are not deposit obligations, they are generally dated, debt instruments such as commercial paper, collateralized loans, repurchase agreements, or claims that have a pay-off contingent on the performance of the firm.
- A need to generally hold liquid, tradable assets that are marked to market daily.

Systemic risk has emerged as an important issue associated with large Investment Banks because of:

- The scale of their global activities including OTC derivatives
- Them being increasingly affiliated with commercial banks and/or insurance companies as financial conglomerates.
- Their large scale.
- Absence of capital adequacy requirements which had been designed primarily for depositor customer protection
- Problems of orderly exit and wind up without disruption of markets and spill-overs to other financial institutions, which was highlighted in the GFC.

Among the Australian Investment Banking sector are international institutions such as:

- **UBS**: which describes its activities as a *corporate client solutions business* which covers "all advisory and solutions businesses, origination, structuring and execution – including equity and debt capital markets – that involve corporate, financial institutions and sponsor clients" and an *investor client services business* which covers "execution, distribution and trading for institutional investors. It comprises UBS's leading equities businesses, together with FX, flow rates and credit facilitation".
- **Morgan Stanley**: which describes its activities as *Wealth Management* (advising and managing client assets of high net worth individuals and families, not-for-profit organisations, executives and professionals); *Investment Banking and Capital Markets* (advising corporations, organisations and government clients on transactions including mergers, acquisitions, restructurings, initial public offerings (IPOs)), *Sales and Trading* (finding new forms of investments to generate superior returns) and providing sales, trading and market making services), *Research*.

One Australian investment banking firm is *Bell Financial Group (ASX: BFG)* which provides "stockbroking (full service and online), investment and financial advisory services to private, institutional and corporate clients". Another is *Ord Minnett (Ords)* a "wealth management group, offering a full-service stockbroking, financial planning, funds management and portfolio services" and with "specialist corporate finance, fixed interest and asset management teams". Both of these examples are best known for their provision of stockbroking services to individuals.

2.5 Trustee Companies

Somewhat confusingly for non-lawyers, a trust is not a legal entity, even though it is treated for taxation purposes as a separate entity, albeit with special rules. A trust is a legal arrangement whereby assets are held and managed on behalf of the beneficial owner(s) by a designated trustee. The trustee has a fiduciary duty to act in the interest of the beneficiaries of the trust.

Trustee companies perform a wide range of functions. At one level, they provide services to families to help manage wealth, including acting as executors of deceased estates. At another level, they may be appointed by companies raising funds to act as a trustee on behalf of investors and providing administrative functions such as distributing payments. The Corporations Act (Section 6-1RAC) refers to traditional trustee company service and estate management functions as encompassing the first group of activities, but not the second (ie not operating a scheme, providing custodial services, acting as a trustee for debenture holders etc).

In 2009, regulation of Trustee companies switched from State and Territories to the Federal Government with the passing of the Corporations Legislation Amendment (Financial Services Modernisation) Act 2009. This required, *inter alia,* Trustee companies to hold an appropriate AFSL, imposed minimum capital requirements, and being subject to the regulation of ASIC.

As well as specialised trustee companies, banks also provide trustee services to their customers. Some Australian banks have, however, moved away from the trustee business. For example, in September 2017 NAB sold its National Australia Trustees Limited business to Australian Executor Trustees, while in April 2014, ANZ Trustees was sold to Equity Trustees Limited. Most of the trustee companies have become members of more diversified financial services groups. The largest private trustee companies in Australia are:

- Equity Trustees (subsidiary of ASX listed EQT, formed in 1888)
- Australian Executor Trustees (owned by IOOF until December 2022, now part of Equity Trustees)
- Trustees Australia became Cashwerkz (CWZ) in 2019, part of Income Asset Management

- Perpetual Trustee Company (formed in 1886, part of Perpetual Financial Group)
- Sandhurst Trustees (owned by Bendigo and Adelaide Bank)
- Australian Unity Trustees (licensed in 2017, owned by Australian Unity, the first new license since the 2009 legislation)

In addition to these private trustee companies there are government owned ones in most states, such as State Trustees in Victoria, which focus mainly on providing services to individuals.

A peculiarity of the Australian financial system is that public investment trusts (managed investment schemes/funds) are not required, since the passing of the Managed Investments Act (MIA) in 1998 to have a trustee separate from the manager of the fund. Rather, a *Responsible Entity (RE)* is required who can simultaneously be the manager of the fund but who is required to put the interests of the investors first. (Even when not in the RE's best interests as a profit seeking entity!) The large trustee companies often assume the role of the RE when marketing managed funds operated by foreign fund managers to investors.

The MIA was repealed in 2016 (but the RE requirements persist in Part 5C.2 of the Corporations Act).

2.6 Collective Investments (Managed Investment Schemes)

Managed Investment Schemes accept funds from investors which are pooled for particular forms of investment specified in their constitution (or other legal documents) such as: shares, money market and debt securities, real estate (A-REITs), agricultural ventures.

They are often referred to as mutual funds. Investors have pro rata claim on assets of the fund and income generated from those assets based on the size of their investment. ASIC provides information about legal issues involved in managed fund operation, and a list of types of schemes, here while Mees, Wehner and Hanrahan (undated) provide a comprehensive historical overview of the funds management sector in Australia from the 1950s to the early 2000's.

MIS are established and run by a manager/trustee (for a fee). In Australia a unit trust model has been common. This involves a tax "pass through" structure, such that earnings are not taxed in the fund as long as the trustee distributes all earnings to investors. The 1998 Managed Investment Act (now part of Corporations Act) in Australian led to a Responsible Entity (RE) model, in which the need for a separate trustee was abolished and the RE acts both as the manager and trustee. The RE has fiduciary responsibility and is required to act in the best interests of the members (investors), even though this may be in conflict with their own best interests.

Other vehicles are found overseas, generally not using the trust structure but instead some collective corporate investment vehicle (CCIV). Legislation in February 2022 enabled introduction of such a form for Australian collective investments and ASIC has provided regulatory guidance regarding establishing a CCIV). One rationale for this change is to allow structures more familiar to foreign investors as part of the introduction of Asian regional funds passports enabling fund managers to more easily operate in other jurisdictions by recognising the regulation of the home jurisdiction. Unlike a trust, a CCIV is recognised as a separate legal identity, with no employees other than its single corporate director (who has an appropriate AFSL) and can offer multiple sub-funds to either or both retail and wholesale investors. More detail is available here. Figure 2 (from the Explanatory Memorandum for the legislation) provides an overview of the structure. As at early 2023 there had not been many CCIVs created in Australia.

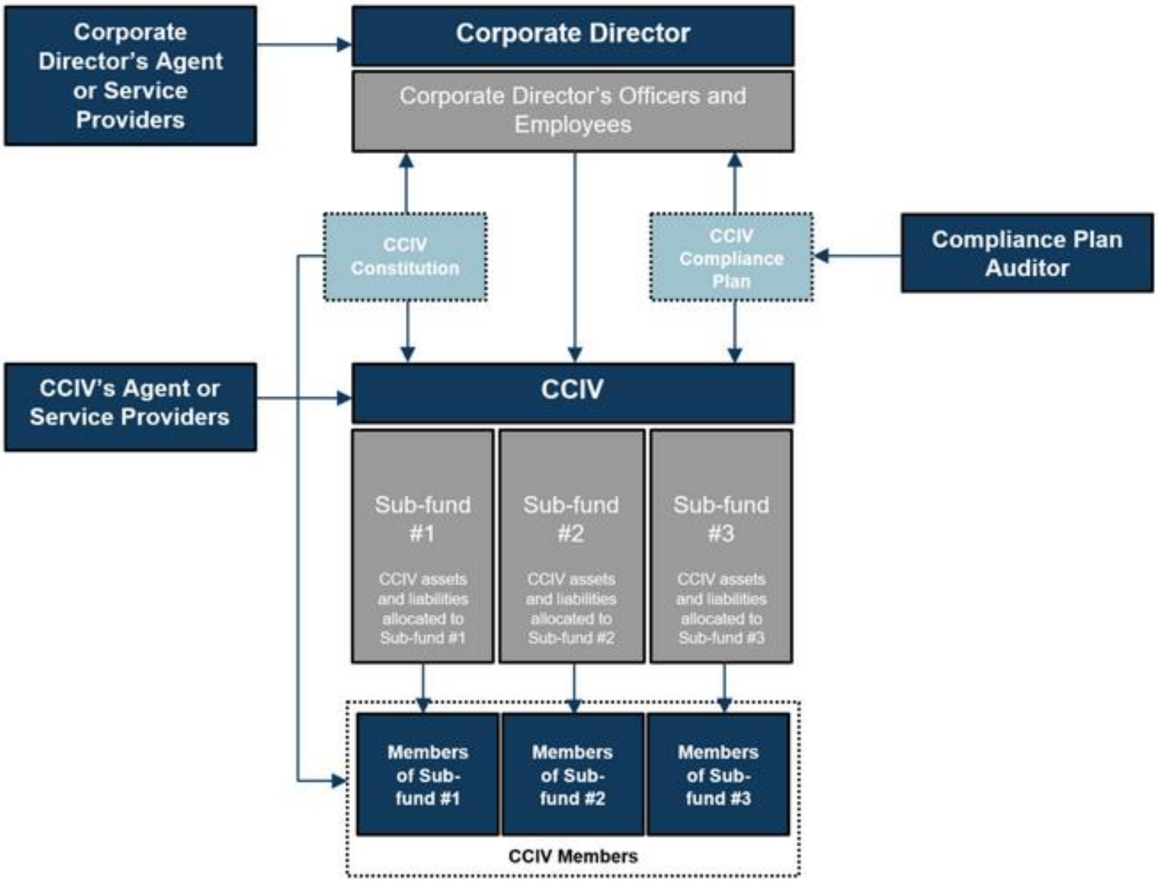

FIGURE 2: CCIV STRUCTURE

Also common are limited partnerships (often used by hedge funds), in which the manager is a “general partner”, responsible for decision making and not protected by limited liability. The investors who are “limited partners” do have limited liability protection by virtue of having little or no "voice" (participation in management). Moreover "exit" (withdrawal of funds) is likely to be constrained by the terms of the investment agreement. In Australia, except for venture capital funds, there is not the "pass-through" tax treatment commonly found overseas (although see here for discussion of recent court rulings which complicate matters).

An important distinction is between "closed end" and "open end" funds. "Closed end" funds issue a fixed number of units to investors and these can then be bought or sold on the stock exchange. The unit price varies with demand/supply pressures and may vary from the underlying Net Asset Value (NAV). New funds may be raised from time to time by the issue of more units

"Open end" funds involve a variable number of units. Investors can buy and sell units from the manager, typically at a small spread to the end of day price. The unit price generally equals NAV as a result. The potential for a "run" of unit holders means that liquidity management is important.

Exchange Traded Funds (ETFs) were introduced in the 1990s and are structured to allow exchange based trading, with a mechanism incorporated to ensure that price equals NAV. Retail investors buy and sell on the exchange, like a closed end fund, but designated market makers can create additional units by delivering underlying assets to manager (when price moves above NTA, or extinguish existing units by delivering existing units to manager in exchange for underlying assets (when price falls below NAV). The mechanics are explained by Vanguard Investments (one of the major providers of ETFs) here.

2.7 Cash Management Funds (CMTs)

CMTs are open-ended funds often known in other jurisdictions as Money Market Mutual Funds. They are mutual funds that specialise in investing member's funds in short term securities, such as bank deposits, promissory notes, government treasury notes etc. Their rationale for existence is that by aggregating funds from retail investors they are able to access wholesale market interest rates. With CMTs having relatively low operating costs, the retail investors should obtain better returns than they could from making direct investments in short term liquid securities or bank deposits, while still having virtually immediate (next day) access to their funds. Investors may also benefit from the ability of the specialist managers to identify opportunities to purchase undervalued securities, without taking on significant risk – although the evidence does not support such arguments. Indeed, one concern is that managers may invest in short term securities of issuers with higher default risk in search of higher returns – to attract investors and grow funds under management (and thus fees). In general, the constitution of the fund will specify limits on acceptable investments.

CMTs should be a source of competition for retail bank deposits, since they offer liquidity and potentially higher returns. And when CMTs were growing strongly, banks responded by creating new forms of deposits known as Cash Management Accounts (CMAs). These may limit the number of withdrawals per period and typically offer a "tiered" rate structure of higher interest rates for larger balances, and which may be changed at any time in response to movements in wholesale market rates.

It can be seen from Figure 3 that Australian CMTs grew quite rapidly in the 1990s and early 2000's up until the time of the GFC, since when the sector has general declined in size. The number of CMTs in operation also followed a similar pattern. The Macquarie Bank CMT was closed in 2010 and client funds transferred to a Cash Management Account.

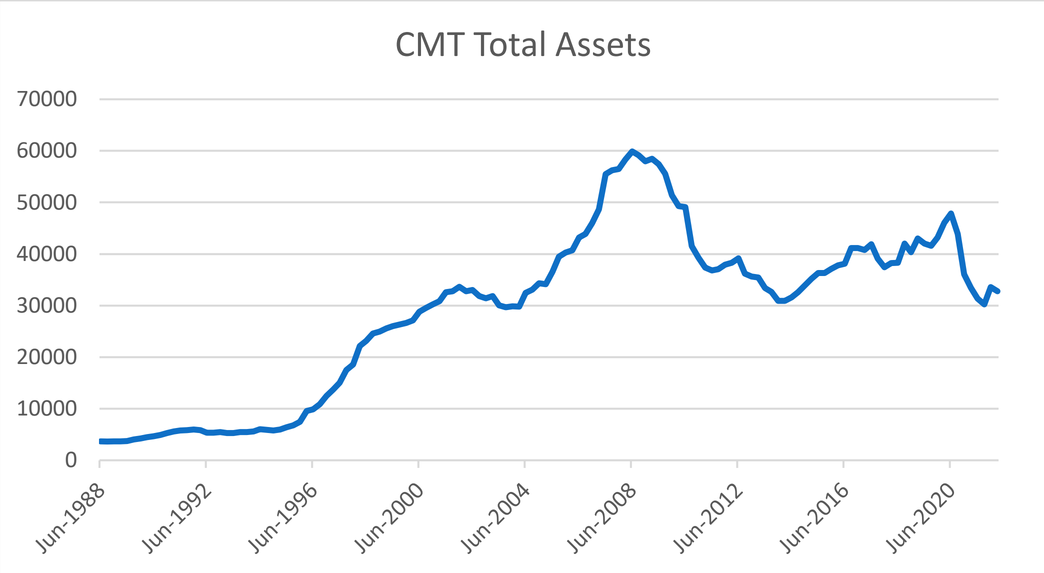

Figure 3: CMT Growth (Source ABS *Managed Funds Australia, table 8*)

Behind this marked decline in CMT market size following the GFC was the introduction of the Financial Claims Scheme in 2008 which initially provided insurance protection to ADI deposits of up to $1 million and to $250,000 after 2011. Faced with a choice between protected bank CMA deposits and unprotected CMT investments, it is hardly surprising that CMTs became less attractive to retail investors with amounts to invest below those insurance caps. Investors with larger sums to invest (and not wanting to diversify across deposits at a large number of banks) may still have found CMTs attractive if rates were better than available in bank CMAs. However, as this article in ANZ's *Blue Notes* explains, liquidity regulation introduced as part of Basel 3 in 2016 created further handicaps for CMT growth. Because deposits made by CMT's with banks are treated as potentially volatile, their use by the bank is in effect limited to investing in low yielding liquid securities rather than higher yielding loans. Consequently banks offer low rates to deposits made by CMTs, reversing what was a typical pattern of large deposits receiving higher interest rates than smaller (retail) deposits. To offer better rates than bank deposits, CMT managers are therefore essentially forced to focus on alternative securities investments. These do include, however, bank negotiable certificates of deposits (NCDs) which may have longer term maturities, and thus are not affected by the liquidity regulation. While investing in longer term maturities creates interest rate risk, the NCDs can be traded in the secondary market.

2.8 Pension Funds (Superannuation)

These are collective investment vehicles accepting long term retirement savings with limits on the minimum ("preservation") age at which a member can withdraw their investment (unless transferring to another fund).[3] Concessional tax rates apply on employer contributions on behalf of employees to the fund, earnings within the fund, withdrawals in the retirement phase.[4]

Most funds in Australia are "accumulation" (defined contribution) funds where the value of the member's investment is determined by their pro rata share of the value of assets in the selected investment portfolio operated by the fund. "Defined benefit" funds (becoming less common and covering only about 10 percent of fund members) involve the operator of the fund giving a promise of a guaranteed amount (generally linked to time in the fund and some level of salary during (or at the end of) that time (and contributions made) to the member on retirement. The operator (often the company or government body employing the members) has an exposure to differences in the value of fund assets and the value of promises made.

In many countries (see here for comparative information) there is compulsory membership of some pension scheme for employees. Voluntary contributions may be possible and there may be significant tax concessions associated with contributions, fund earnings, and payouts.

Australian types of super funds include:

- Retail (operated on a for-profit basis by banks or other financial institutions)
- Industry funds (operated on a not for profit basis by a board of trustees selected by the relevant union and employer associations)
- Corporate funds (provided for its employees by a company)
- Public Sector Funds (for government employees), and

[3] In 2020, the Covid19 crisis led the Federal Government to permit limited access (maximum $20,000) for individuals below the preservation age in financial hardship.
[4] In discussions of pension fund taxation, a triplet such as (t,t,0) is used as shorthand for tax rates applying respectively to contributions, earnings in accumulation phase, and retirement phase, where "T" stands for full taxation, "t" for concessional taxation, and "0" for no taxation. For Australia the triplet is (t,t,0) – where t = 15%, although (as in most cases) there are other complicating tax factors such as a lower tax rate (10%) applied to earnings in the form of long term capital gains, and ability to use franking credits attached to dividend income to reduce the effective tax rate below 15%. (It is generally around 10 per cent).

- Self Managed Super Funds (SMSFs) of four or less members where the members are also the trustees of the fund.

The main activities of superannuation funds are the provision of long term retirement savings schemes involving investment of members' funds, and providing retirement income products. They perform valuable economic functions. First, they reduce transactions costs associated with the process of collecting, managing, and ultimately drawing down long term savings (and complying with regulations associated with any preferential tax treatment accorded to such savings). Second, they pool funds from multiple contributors and are thus able to provide access to a broader and diversified investment universe. Third, they provide access to specialized investment knowledge to manage risk and possibly generate higher risk-adjusted returns for savers. Fourth, the range of financial products offered by pension funds increases the opportunity set available to individuals and may involve risk transformation and risk bearing by the fund managers (such as in the case of defined benefit products). Fifth, their investment activities transmit any specialist information they have generated into financial market prices and may also involve governance and monitoring activities over firms in which they have equity investments.

This sector was given a significant boost when compulsory superannuation was introduced via the Superannuation Guarantee (Administration) Act in 1992, and the current regulatory framework established via the Superannuation Industry (Supervision) Act in 1993. Figure 5 illustrates its growth in terms of total superannuation sector assets relative to GDP, and also the changing relative importance of types of funds. Corporate Funds have stagnated, and while all other types have grown, the growth has been most marked in the Self Managed Super Fund (SMSF) and Industry Fund Sectors. The huge growth in assets under control of superannuation funds gives them an important role in both corporate funding and funding of other financial institutions (including banks).

As at early 2023, the compulsory contribution rate was 10.5 per cent of salary (after being fixed at 9.5 per cent for some years), with legislation having been passed earlier for eventual increases to 12 per cent. There is ongoing debate about fund performance and fees, member choice of (or allocation to) fund, tax concessions for superannuation, suitable retirement income products, and a range of other issues. The 2020 Retirement Incomes Review provides a wealth of information, as does the 2019 Productivity Commission Report.

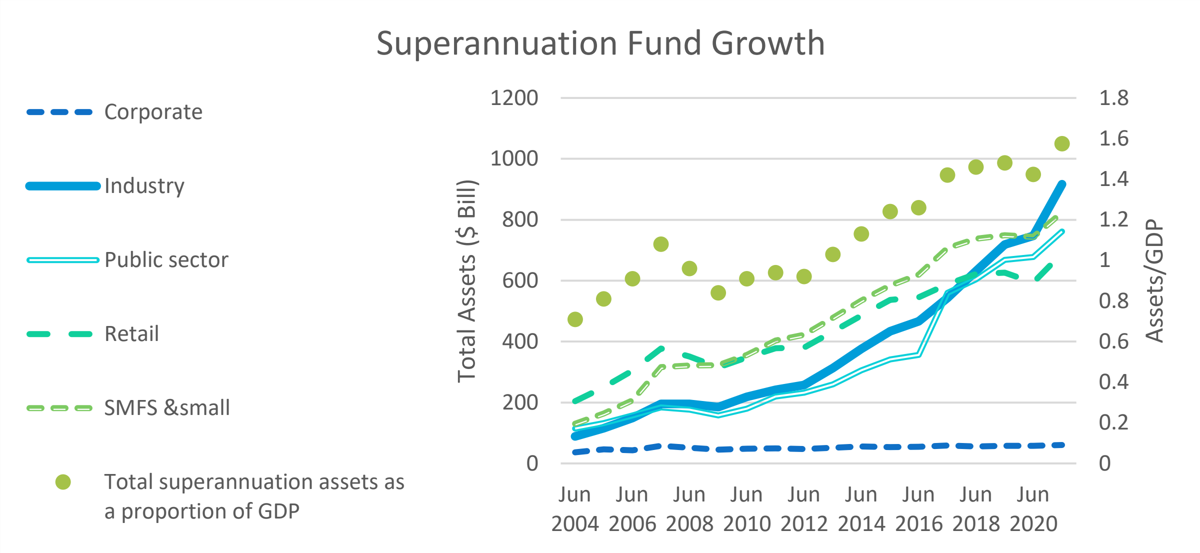

FIGURE 4: SUPERANNUATION GROWTH (*SOURCE: APRA ANNUAL SUPERANNUATION BULLETIN*)

Four main types of funds exist. *Retail Funds are* operated (for profit) by (subsidiaries of) life companies, banks and other financial institutions acting as SRE's (Superannuation Responsible Entities). Many not for profit *Industry Funds* were created following the 1986 Accord (Mark II) agreement whereby unions agreed to forgo a 3 per cent wage rise in exchange for employer contributions to superannuation. (See here for a chronology of superannuation up till 2010 and here for more recent information). The Industry funds are governed by Boards of Trustees provided by employer groups and unions for the industry sectors they were associated with, although most have since become "open offer" funds available to workers from any occupation. Corporate Funds operated by single employers for their employees have declined in relative importance. Some of these operated as *defined benefit* funds which promised a guaranteed amount (or pension) linked to final salary (or some other metric) of the member. Similarly public sector funds operated by governments and their agencies were often defined benefit, but (as with corporate funds) have generally switched to *defined contribution* for new entrants over recent decades. As well as these "Institutional Funds", Self Managed Super Funds, available to groups of up to four (typically family) members have grown significantly while, at the same time, mergers between institutional funds (in search of economies of scale) are an ongoing occurrence. Figure 5 shows the massive decline in the number of corporate funds, a significant fall in the number of retail funds (due to mergers), and strong growth in the number of SMSFs. The number of industry funds has also declined somewhat due to mergers, while the number of public sector funds has declined only marginally.

While in accumulation mode, members of institutional funds are also provided with life and TPD (total and permanent disability) insurance, with annual premiums (determined by insurance company providers of the group insurance on a community rating - ie premiums not related to the individual's characteristics - basis) taken out of their accounts.

In retirement mode, members in defined contribution funds can withdraw lump sums and/or draw funds down from their managed account (at a rate at least equal to the government-prescribed minimum drawdown rate for their age).

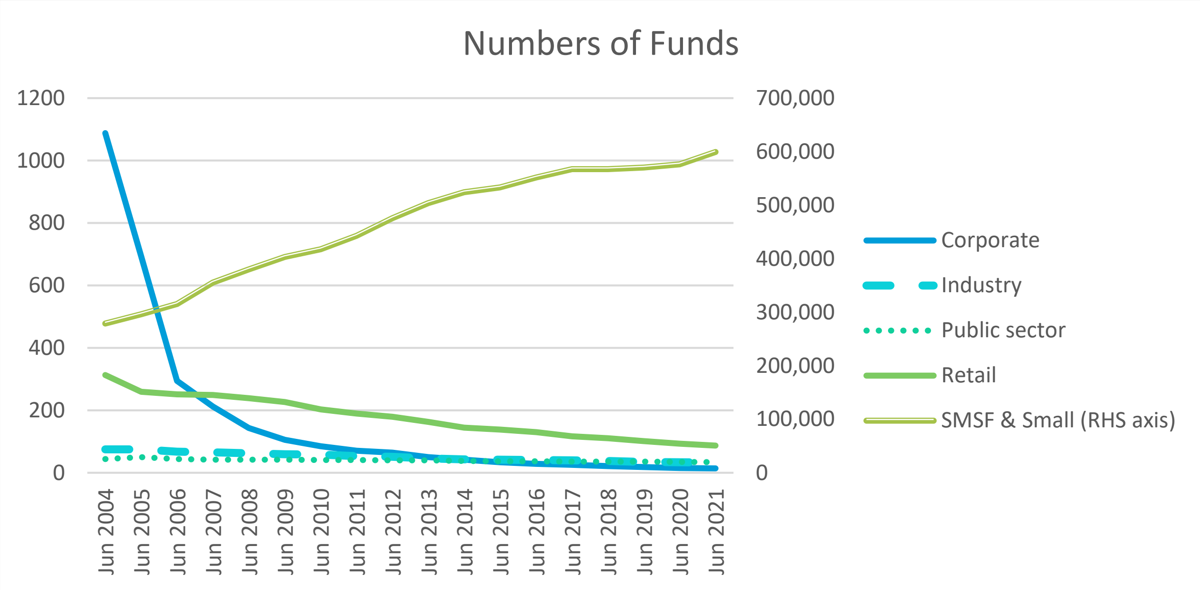

FIGURE 5: SUPERANNUATION FUND NUMBERS (*SOURCE: APRA ANNUAL SUPERANNUATION BULLETIN)*

2.9 Life Offices[5]

These specialise in the provision of life assurance – directly for individuals and via group policies through super funds. They also operate superannuation funds, and are involved in the provision of financial advice and other financial service activities (including general insurance) via subsidiaries. APRA's register lists approximately 27 Australian life offices, including the successors to AMP (whose life business has been owned since 2020 by Resolution Life), CML (owned since April 2021 by AIA) and NML (sold to AXA in 1999 which in turn sold the life insurance business to AMP in 2011). These and MLC (acquired by NAB and largely onsold to Nippon Life in 2015, but still trading as MLC) which were originally, but are no longer, mutual organisations had historically dominated the industry. Australian banks entered, and became a dominant part of the industry in the late 1990s, in some cases via acquisition of life offices, but began to exit the market from 2017. Many of the participants are subsidiaries of foreign financial services firms. Institutional Superannuation Funds provide life

[5] Background papers for the Hayne Royal Commission, available here, and a PJCCFS Inquiry into Life Insurance provide much information about the industry and products.

insurance cover automatically to members for a fee based on “community ratings” rather than individual rating, and this has no doubt contributed to lack of growth of other life insurance policies.

Life assurance policies can provide cover (involving payouts by the insurer to the insured) against events such as death, total and permanent disability (TPD), income protection, and critical illness or trauma. Generally, life cover in Australia is now via annually renewable policies. Historically (and still common in some other jurisdictions) whole of life/endowment policies were common and included a savings component. For such policies, rather than a premium schedule which increased with age (reflecting risk), a level schedule was used meaning that premiums in the early years exceed the cost of cover for that year. The residual was a form of savings which the life office could use to invest in assets to generate earnings accruing to the policy holder (or their estate) at death or some specified age. This long term savings/investment feature was a key feature, but its attractiveness disappeared when tax deductibility of premiums was abolished in the 1980s. (High operating costs in the form of commissions to agents and brokers selling life insurance policies led to relatively poor returns for policy holders). Some life companies (Challenger in particular) provide annuities but these have been out of favour over recent decades (although there has been some growth in recent years).

Some life companies came in for considerable criticism from the Hayne Royal Commission, particularly over unfair claims settlement practices, and also for failures in their advice activities.

2.10 Friendly Societies

Wettenhall (Pursuit, 2018) provides a concise overview of the history of friendly societies in Australia, noting that “Before governments stepped in to provide welfare, friendly societies provided vital financial and social support to many Australian communities”. The benefits they provided included medical care coverage, funeral benefits, sick pay insurance. Downing (2012) examines how friendly societies changed in Australia in the half century prior to the First World War.

Nowadays, the small number remaining are a form of insurance company. Their main activities involve raising and investing funds from members as well as specific purpose activities (such as health insurance and long term specific savings). The main product is Friendly Society (Insurance) Bonds which are primarily a long term savings vehicle with a specific tax treatment (which is attractive for high marginal tax rate investors). (See here for analysis of their characteristics and role in saving for life-cycle events). There are now a relatively small number of small societies, some such as Australian Unity remain as mutuals. Others such as IOOF demutualised and expanded activities into a broader range of financial services. In early 2023 APRA listed eleven Friendly Societies on its register of regulated institutions.

2.11 General Insurers[6]

These are referred to in some other jurisdictions as Property & Casualty Insurance. They provide house and contents insurance (theft, fire, flood), Car insurance, Professional Indemnity, Third-party liability, Workers Compensation insurance, Business Interruption Insurance, Pet Insurance etc. Some of these types of insurance (3rd party, workers comp) are mandatory for individuals or businesses and in some States are provided by a government insurance agency rather than a private insurance company.

There are a large number of general insurance companies in Australia (some are subsidiaries of overseas insurers). A list of those who are members of the industry association *The Insurance Council of Australia (ICA)* can be found here and APRA's register of general insurers here.

2.12 New innovations: Platforms - Crowd-funding, P2P/Market-place lenders

"Platform based financing" refers to situations in which the platform operator acts as a broker in bringing together those with funds to invest and those seeking funds, via use (typically) of a web site market place. Figure 6 illustrates the structure. It encompasses peer to peer (or market place lending), crowd-sourced equity funding, and other potential activities such as sale of existing securities (trade debtor obligations) by current holders to third parties. Within each sub-category there are a range of different business models and proprietary algorithms used.

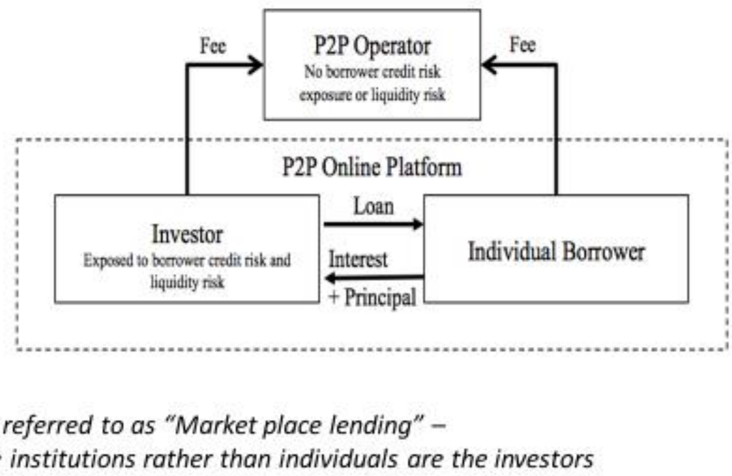

FIGURE 6: PLATFORM BASED LENDING STRUCTURES

The Platform Operator will

- Assess borrower creditworthiness, advertise loan opportunity to investors

[6] The background papers (Nos. 14, 26, and 27) for the Hayne Royal Commission provide information on general insurance.

- Allocate interested investors to (many) borrowers
    - Determine interest rate which funds loan and satisfies investors and borrower
- Transfer loan funds from investors to borrowers, collect borrower repayments and remit to investors

The Investor bears risk of non-repayment by borrower and has funds invested for term of loan. The platform operator, in a "pure" model bears no credit (default) risk or liquidity risk - although many structures will involve special features which can create such risks. Figure 7 illustrates the risks for participants in platform lending arrangements.

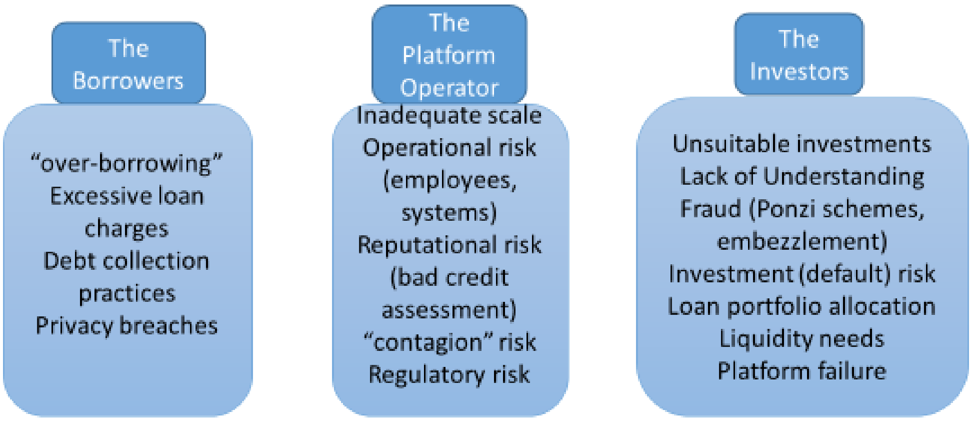

FIGURE 7: PLATFORM LENDING RISKS

Actual and potential business model structures for platform lending businesses include the following.

- Segregated client account models, in which investor funds are applied directly to funding the borrower
- Unit trust structures
- Notary arrangements in which a bank makes the loan on behalf of the platform and immediately provides investors with note giving partial ownership of the loan
- Guaranteed return models in which the platform operator provides a guaranteed return to investors.

Potential benefits from growth of Platforms are:

- Increased access to debt finance for borrowers – financial inclusion
- Wider range of investment opportunities for saver/investors
- More efficient allocation, involving risk based pricing, of finance

- Increased competition for incumbents – pressure for increased efficiency, lower margins, benefits for consumers of financial services

Impediments to growth include

- Unclear regulation
- Regulatory barriers to entry
- Unreliable telecommunications networks
- Inadequate access to credit information
- Customer identity verification problems
- Scale economies and start-up funding

Regulation of Platform Financing is challenging, because it is a relatively new form of financing activities not easily fitting existing regulatory arrangements (which are often based on pre-existing institutional characteristics). P2P operators perform functions similar to: Market (exchange) operators; Provider of individual managed accounts – like stockbrokers; Credit broker; Investment banking (loan "IPOs", issuer of securities, "private placements"); Financial advice; Credit rating agency; Securitiser (pooling loans for investors); Managed investment scheme. (See Murphy and Davis (JASSA 2016) for a discussion)

There are a number of typical types of regulatory approaches found globally (see Figure 8) – although the pace of change is such that any taxonomy is likely to quickly become out of date.

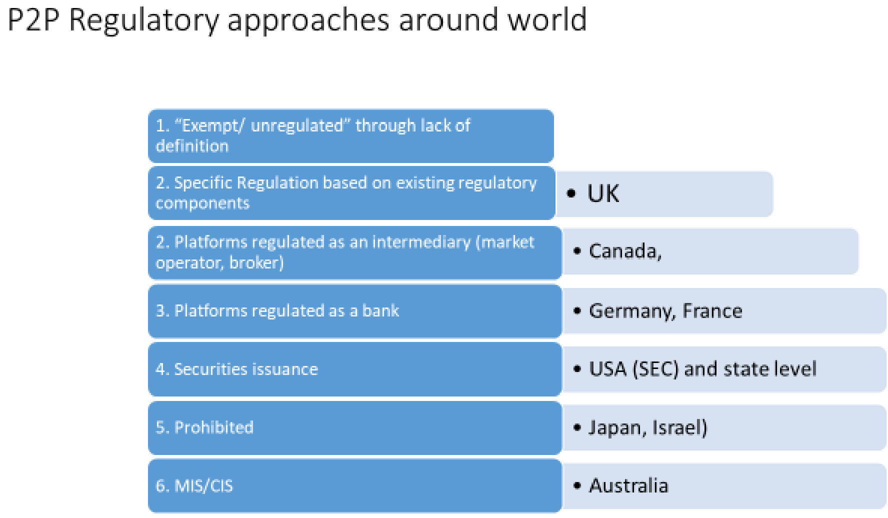

FIGURE 8: REGULATORY APPROACHES TO P2P LENDING (AS AT 2017)

In Australia, P2P platforms have tended to adopt the label of "market-place" lenders. This reflects the fact that loan funding occurs via their marketplace, but that most of the funding comes from institutional lenders rather than individuals (peers of the borrowers). Indeed a number of institutions have found P2P operators a useful vehicle for expanding their loan portfolios. Credit Unions with members who are primarily savers rather than borrowers have found investing in loans via the P2P platform valuable. This does, of course, raise the issue of whether they can have confidence that the P2P platform is (a) appropriately identifying borrower risk and (b) meeting responsible lending requirements. Other non-bank lenders such as Liberty Finance, which is using MoneyPlace's platform, have done similar. However, in some of these cases, they will simply outsource the handling of loan applications they receive to the P2P operator.

2.13 Custodians[7]

Custodians provide various services associated with asset (cash, shares, bonds, etc) safekeeping and trade settlement to institutional investors such as superannuation funds and fund managers. Table 2 provides a list of custodians operating in Australia and their relative size. They can be seen as a specialised outsourced back-office service, enabling separation of duties between investment managers and brokers and ownership of client assets.

[7] More information available at the Australian Custodial Services Association (and a detailed document here) and also The Clearing House White Paper

Master/Global custodians operate across borders with their sub/domestic custodian arms providing domestic services.[8] Principal services include:

- Custody – asset safekeeping, trade settlement, dealing with corporate actions
- Accounting and valuation, tax reporting, unit pricing (providing “books of record”)
- Regulatory reporting
- Performance measurement and analytics
- Data management
- Trade support

Other services may include such things as securities lending, hedging, collateral monitoring trade execution.

Custodians may establish special purpose vehicles as “nominee companies” to hold client assets. (Consequently, aggregated holdings of their clients’ holdings of shares in particular equities typically show up in the lists of top shareholders in Australian companies – hiding the identities of the ultimate beneficial owners).

With the significant growth of investment funds in recent decades, Australia has become a major regional hub for custody and investment administration services. Total assets under custody for Australian investors were $4313 billion at June 2022 up from $1,360 billion, as at 31 December 2006[9]. Around ¾ of those assets were domestic (versus foreign) assets. Custodian services for Australian assets of foreign investors are also provided.

Most Custodians are typically bank-owned entities, and those operating in Australia must have an AFSL. The custodian is a trustee of assets and must act on instruction from the beneficiaries.

[8] **Domestic Custody**: Australian assets held directly in the capacity as custodian or sub-custodian.
Global Custody: The safekeeping of assets (other than Australian) either directly through a proprietary global custody network or via a global sub-custody network. Includes managed funds/unit trusts domiciled offshore and held by Australian clients.
Master Custody: Includes assets held for Australian domiciled clients for which an organisation performs any value added services, where value added is defined as being anything in addition to core custody. Assets included in this category are likely to have also been included in the Domestic Custody and Global Custody categories. To prevent double counting, where value add services are being performed for multi-tiered/fund-of-fund structures assets are only included once, and not duplicated at each level of the structure.

[9] The Australian Custody Services Association (ACSA) Statistics Report (Dec 2006)

TABLE 2:AUSTRALIAN CUSTODIANS AND AUSTRALIAN INVESTOR ASSETS UNDER CUSTODY (SOURCE: ACSA)

Rank	Provider	Dec-21	Jun-22
1	J.P. Morgan	$1,109.9	$983.7
2	Northern Trust	$730.0	$679.3
3	Citigroup	$801.8	$678.8
4	State Street	$580.5	$625.4
5	NAB Asset Servicing	$579.3	$509.4
6	BNP Paribas	$494.5	$441.9
7	HSBC Bank	$219.7	$197.1
8	Clearstream	$106.5	$104.2
9	Netwealth	$56.6	$55.7
10	Apex Group	N/A	$25.8
11	BNY Mellon	$16.6	$12.1
	Total	**$4,695.3**	**$4,313.4**

2.14 Islamic Finance

The three per cent of the Australian population who want financial products which are Sharia-compliant face significant problems in accessing such products.

Islamic Finance has a number of characteristics, the best known one being a prohibition on interest. Others include limits on acceptable insurance arrangements and restrictions (which look much like Socially Responsible Investment criteria) on acceptable investments. This video lecture by Prof Mervyn Lewis provides an overview, while this paper by the same author provides an analysis of Islamic banking.

Personally, I don't see the point of these religious-based constraints – but in a free society governments should not put unnecessary impediments in the way of those who want to adhere to them. More importantly, it should be a concern that some regulations, such as compulsory superannuation, and institutional indifference, virtually force individuals into financial products not compatible with their beliefs. Taxation laws and policies can also be an issue, and this was investigated in a 2016 report by the Board of Taxation

Among the various problems which exist, two in particular stand out. The first is the question of designing Islamic financial products enabling families to buy homes. Because interest is prohibited, a conventional mortgage loan is not acceptable.

As in many other situations, Islamic finance works around this by some simple financial engineering. The financial institution buys the house an individual wishes to own, and leases it to the individual on agreed terms in a long term contract. At the end of the contract the ownership of the house is transferred to the individual.

The impediment to this simple work-around has been double stamp duty, once on the initial purchase by the financial institution and second when the house is transferred to the owner at the end of the lease. Under conventional mortgage finance, stamp duty is only levied once when the house is initially purchased. And stamp duty, levied by State governments has been significant – up to 6 per cent of the house value!

While the Victorian government has removed this impediment, by allowing house purchase under Islamic financing arrangements to only incur one lot of stamp duty, other State governments have been unwilling to take that step. Perhaps it is the potential revenue cost – although if double duty prevents use of the Islamic finance approach, there is little revenue actually to be lost!

An alternative design, whereby the homebuyer is registered as owner when the property is bought is a form of "rent to buy" scheme. The rental payments made repay the amount borrowed plus some profit fee for the provider of the funds.

The same problem of obtaining loan finance arises for Islamic financing of small business enterprises, and may be compounded by tax and legal issues.

A second area warranting attention is superannuation. All employees, regardless of their religious faith (or lack thereof) have compulsory contributions paid by their employers into a super fund of their choice. And, there are significant tax advantages for voluntary contributions as well.

But what does the typical institutional super fund's portfolio allocation look like? Even allowing for the provision of member choice between different investment options, the only portfolios generally available will have a significant fixed interest component.

This portfolio allocation is based on the widely held view of trustees that prudent asset allocation involves a significant share of investments paying interest. That is not particularly comfortable for the member wanting to have only Sharia-compliant investments. Another problem arises from the prohibition of investments in certain types of activities (including businesses generating income from charging interest, alcohol, tobacco, gambling etc).

In principle, it would be possible to construct portfolios which do not have an interest component but which have some "fixed-interest like" investments. Established infrastructure assets are one example. Lease income is another example, such as might flow from Islamic financing of home ownership as discussed above. But more relevant is whether conventional institutional norms about what are acceptable portfolio allocations for super, and institutional inertia, should prevent or inhibit Sharia-compliant super options being offered to individuals forced to invest in super.

One response may be that self managed super is always an option – but that is only a cost-effective option for individuals with substantial super savings. While it does look as though some institutional super offering of Sharia-compliant super is now emerging – the impediments and lack of institutional interest have apparently been substantial.

Will Islamic finance grow in Australia? Probably yes, but primarily in the context of what is needed to make investment in Australia attractive to wealthy international Islamic investment houses – because that caters to the interests of, and potentially benefits, the financial community. That issue is worthy of attention, but there is probably more value in focusing on whether impediments to providing suitable savings and funding vehicles affecting this group of individuals and businesses can be reduced.

There are a number of Islamic financial institutions operating in Australia. These include Islamic Co-operative Finance (IFCAL), IBA, MCCA, Crescent Wealth. In mid 2022 IBA Group – Islamic Bank Australia secured a restricted banking licence from APRA, enabling it to offer deposit products to a restricted group of customers, with the hope to achieve a full licence within two years. Several of the major banks have offered Shariah-compliant products for use by Islamic financial institutions and individuals.

2.15 Other types of financial institutions

Any attempt to provide an exhaustive list of financial institution types is confounded by changing practices including developments in fintech. As well as those relatively well known types considered above, others described elsewhere in this book are:

- Payday lenders (see section 8.5)
- Pawnbrokers (see section 8.4)
- Buy Now Pay Later (see section 8.7)
- Supply Chain Financiers (see section 8.3)
- Microfinance institutions (see section 8.8)

- Remittance providers (see section 14.4 and here)
- Central clearing counterparties (CCPs) (see section 26.7)