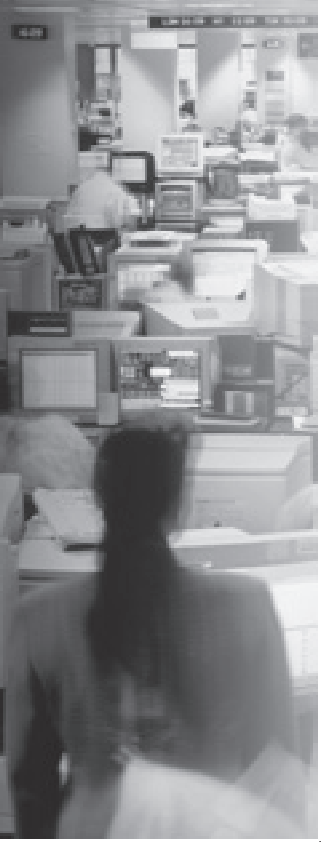


Part 1

A modern financial system: an overview

Financial systems within developed economies are essentially similar in their structure and operation. Generically, institutions, markets and instruments are fundamentally alike, but may often be differentiated by size, terminology, and the level of government regulation and prudential supervision. Students should therefore appreciate that their understanding of the modern financial system will be universal in nature.

While each nation-state is responsible for the structure and operation of its own financial system, today, each financial system is a part of the global financial system. Internationalisation of financial markets, supported by the adoption of sophisticated technology- based information and product delivery systems, has resulted in the development of new products and markets, and an enormous increase in the volume and speed of the flow of funds through the international money and capital markets.

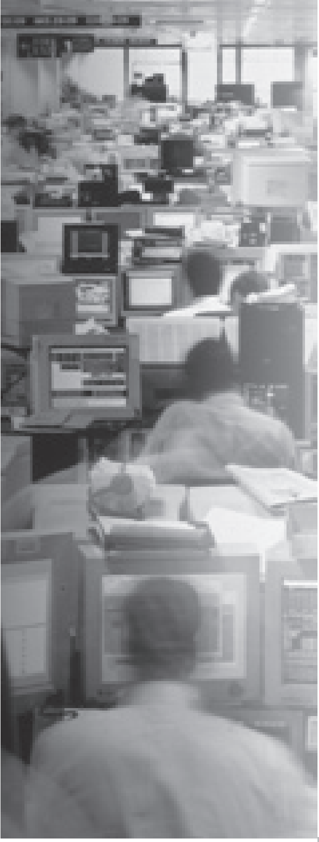
This book primarily focuses on a study of the Australian financial system, which is an efficient and modern financial system operating effectively within the overall global financial system.

The financial system can be thought of as being composed of the myriad markets and institutions through which funds flow between lenders and borrowers. The institutions that facilitate the flow of funds also have the important responsibility of developing financial instruments and techniques that appeal to savers, and that therefore provide incentives to save. The institutions simultaneously have to develop instruments and products with features that suit the needs of borrowers. The financial system is also important in providing the framework and markets through which government affects the flow of funds. The government's influence is exerted through laws and regulations relating to the operations of the financial institutions thatwhich participate in the financial system, and through its influence on ability to affect the general level of interest rates.

The financial system is thus a vitally important and integral part of the overall economy. By encouraging savings, and through the allocation of savings to borrowers, the financial system plays an important role in the investment process, which is a major determinant of the economy's growth and future productive capacity. It is important also in providing the framework for the implementation of the government's interest rate and regulatory policies.

The purpose of Part 1 is to present an overview of the modern financial system, and to provide a context for the more specialised parts, thatwhich provide a detailed study of the main financial markets, instruments and techniques. Chapter 1 introduces the main functions of financial markets, and provides an overview of the types of instruments that are created within the markets. The institutions that comprise the financial system are also introduced. Chapter 1 concludes with a case study, being an examination ofon the Asian financial crisis, which that has had significant ramifications for nation-state financial systems within the region and for the global financial system generally.

Given the significance of banks, asbeing the largest of the institutions involved in facilitating the flow of funds between savers and borrowers, Chapter 2 is devoted exclusively to a detailed analysis of their roles and functions. Chapter 3 details the operations and significance of the main non-bank financial institutions. In both chapters the approach emphasises the role of the institutions in the flow of funds by focusing on their respective sources of funds and their uses of those funds. The other theme that runs through the two chapters is the role of official regulations, and changes in the regulatory and prudential supervision framework, in explaining the changing relative importance and functions of the various institutions.



3

Non-bank financial institutions

General aims

The general aims of this chapter are to:

- develop an understanding of the importance of non-bank financial institutions in the flow of funds;
- explore the range of financial products and services offered by the non-bank financial institutions;
- detail their principal sources and uses of funds;
- consider the main regulations imposed on their operations;
- explore the impacts that regulation and deregulation of the particular institutions, and of the banks, have had on their development.

Learning objectives

The following more specific learning objectives are a checklist against which to assess your progress and competence. The end-of-chapter review questions should also help you assess your progress.

Having worked your way through Chapter 3 you should be able to:

- identify the main non-bank financial institutions, and outline for each type of institution itstheir current share of assets of all financial institutions;, and explain factors whichthat have affected the structural balance sheet changes that have occurred;
- define what is meant by 'contractual savings institutions', giving examples of the main categories of such institutions in Australia and

indicating their relative importance in the flow of funds; outline the nature of the sources and uses of funds for each type of institution, and identify factors that have impacted on their rates of growth;
- explain why superannuation funds have increased in relative importance during the 1990s and should continue to do so into the next century;
- define and outline the main functions of finance companies; explain changes that have occurred in the relative importance of finance companies;
- define the roles, and identify the sources and uses of funds, of 'money market corporations' (more commonly known as 'merchant banks' or 'investment banks'); explain the environment that facilitated the rapid growth of merchant banks; outline the recent changes in their relative importance, and indicate why it may be more appropriate now to refer to many 'merchant banks' as 'investment banks';
- outline the roles and relative importance of non-bank depository institutions, and provide explanations of their recent growth performance;
- explain the function and operation of managed funds, and. iIdentify factors that have influenced their growth over the past decade;
- outline the main features of cash management trusts, and account for their growth performance over the past decade; and
- define a 'public unit trust', indicate the range of the assets of trusts, and outline the differences between 'listed trusts' and 'unlisted trusts'.

3.1 Introduction

This chapter completes the examination of the main institutional aspects of a modern financial system. For each of the institutions dealt with in this chapter, the main activities of the institution will be analysed. Their sources of funds, and the uses to which the funds are put, are detailed, and the main elements of the regulatory environment within which they operate are also outlined. It is emphasised that the various types of institutions have had to be dynamic in their response to changes in their environment. The shape of the financial system is constantly evolving in response to the changing preferences of savers and borrowers, and as changes in the regulatory environment affect the competitive advantage of each type of institution.

Fig. 3.1 Financial markets and flow of funds relationships

The chapter opens with an examination of the second- most- dominant sector of the market, based on share of total assets of financial institutions:, the contractual savings institutions—: insurance companies and superannuation funds. These institutions principally operate at the 'long end' of the maturity spectrum since they generally have long-term committed funds as their main sources of funds. We then consider three categories of institutions that are considered to have generally been adversely affected by changes in the regulatory environment:. They are finance companies, money market corporations, and the non-bank depository institutions (permanent building societies and credit unions). The next section briefly outlines the role and operation of managed funds, and in particular the nature of the activities of cash management trusts and public unit trusts, which, over recent years, have been high- growth institutions. The final section appears as a matter of record in an examination of the authorised money market dealers. The previously important role of the dealers in the official money markets has been replaced with new operational procedures.

Example 1

Current corporate bond yields in the market are 8% per annum. An existing corporate bond, with a face value of $100 000, paying 10% per annum half-yearly coupons, maturing 31 December 2003, would be sold on 20 May 2001 at a price of:

(a)

$$P = \$100\ 000(1 + 0.04)^{-12}$$
$$P = \$62\ 459.70$$

3.2 Contractual savings institutions

The liabilities of this type ofcontractual savings institutions are defined by contracts for future payments to the subscriber of funds following the occurrence of specified events or conditions. The three types of institutions that issue such contracts are life insurance companies,; general insurance companies,; and superannuation and approved deposit funds.

3.2.1 Life insurance companies

Regardless of the motivation of the person paying premiums for insurance cover, from the point of view of the economy insurance premiums are a form of savings. The accumulated savings are available for investment by the insurance company. The company is only required to make payment to the insured party, or beneficiary, only if a specified event occurs,; for example, the death of the insured. Insurance companies can thus be viewed as intermediaries in the transfer of funds between ultimate savers and borrowers. It is clear from Table 3.1 that life insurance companies are significant institutions in the accumulation of funds within the financial system, and therefore have an important role to play in the flow of funds through the system.

Sources and uses of funds

Life insurance companies obtain their funds through the regular payment of premiums by the holders of life insurance policies and through scheduled contributions to members' superannuation funds. The inflow of funds is regular, relatively predictable and long term. This gives the insurance companies, in aggregate, a very stable level of liabilities. Since their payment flows to policy-holders and superannuants can also be reasonably well predicted on an actuarial basis and are not subject to erratic, seasonal fluctuations, life offices are well placed to invest a large proportion of their funds in long-term securities. It is clear from Table 3.1 that life offices hold large amounts of corporate securities (shares, debentures and notes), and are major providers of debt and equity finance to the business sector.

The prominence of shares, debentures and notes, and other investments, among their assets has increased sharply since September 1984. Until then, under the '30/20' ratio, life offices were required to hold 30% of their assets in government and semi-government securities, with at least 20% of total assets being held in Commonwealth government securities. In return for compliance with the 30/20 ratio, life offices received concessional tax treatment from the government.

Table 3.1 Life insurance companies: select assets held in Australia ($millions, at end June)

Assets	1980	1985	1990	1995	1998
Cash and deposits	n.a.	n.a.	2 685	4 913	9 850
Short-term securities	n.a.	n.a.	5 358	9 929	14 935
Commonwealth government securities	2 873	4 930		8 936	12 131
State and local government securities	1 264	2 293	16 336 (*a*)	13 170	10 898
Other long-term securities	n.a.	n.a.		6 602	10 011
Loans and placements	1 720	2 901	10 693	5 809	8 171
Equities and units in trust	2 997	7 169	21 623	38 073	53 475
Land and buildings	3 267	5 440	13 423	9 487	7 520
Other assets	n.a.	n.a.	6 750	4 385	5 014
Assets overseas	n.a.	n.a.	8 417	17 217	27 016
Total assets	13 652	25 987	85 285	118 523	159 020

(*a*) Commonwealth government, State and local government securities combined.

Source: Reserve Bank, *Bulletin*, December 1998, S62.

The main concession was that investment income earned on their superannuation fund assets was exempt from tax. Another concession was that individuals' life insurance premium payments were tax- deductible for the individual, and this provided an incentive that gave life offices a competitive advantage over other repositories for individual savings. In the years up to 1985, government securities generally comprised the life offices' largest single type of asset, consistently accounting for at least 30% of total assets. Post-1984, government securities have generally comprised less than 20% of total assets. In addition, the composition of this part of their portfolio has changed quite dramatically, with the proportion of local and semi-government securities increasing very sharply.

Regulation

Life insurance offices are regulated by Commonwealth government legislation. Until July 1998 the requirements of the legislation, its associated regulations, and prudential supervision were administered by the Insurance and Superannuation Commission. Following recommendations of the Inquiry into the Financial System (*Wallis Report 1997*) the government established a mega-regulator to act as the prudential supervisor of deposit- taking institutions and contractual savings institutions. The new supervisor is the Australian Prudential Regulation Authority (APRA).