THE AUSTRALIAN BANKING SECTOR REFORMS: PROGRESS AND CHALLENGES

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Abstract

This paper gives an overview of the Australian banking sector; it highlights the reforms since the 1970s; it tracks the growth of the banking sector in response to the reforms implemented over the past five decades; and finally, it highlights the challenges facing the Australian banking sector. The country's banking sector consists of more than 60 commercial banks, with the Reserve Bank of Australia, the country's central bank, at the apex. Since the 1980s, the Australian government has implemented a number of banking sector reforms in order to safeguard and improve the banking sector. The response to these reforms by the banking sector has been varied. As a result of these reforms, there has been an increase in the number of banks and a decrease in the number of building societies and credit unions. There has also been an improvement in the central bank's oversight of the financial institutions, and an enforcement of the banks' capital-adequacy requirements. Currently, Australia has one of the most developed banking systems in the world. The country has enjoyed a substantial bank-based financial sector development over the years, and its institutional framework has also grown stronger. However, like any other country's financial system, the Australian banking system still faces wide-ranging challenges, such as bank concentration and exposure.

Keywords: Australia, Reserve Bank of Australia, banking sector, reforms

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1 Introduction

The role of banks in economic development is widely acknowledged in the literature. In particular, Schumpeter (1911) put the role of financial intermediation at the centre of economic development. He argued that financial intermediation, through the banking system, plays a pivotal role in the economic development; and it does this by affecting the allocation of savings, thereby improving productivity, technical change and the rate of economic growth. Additionally, banks play a central role in the development of every economy by mobilising resources for productive investments, and by being the conduit for the implementation of monetary policy (Sanusi, 2011).

In support of the importance of banks in the economic growth of a country, Boyd and Prescott (1986) model the critical role that banks play in easing information frictions and therefore in improving resource allocation, while Stiglitz (1985) and Bhide (1993) stress that stock markets will not produce the same improvement in resource allocation and corporate governance as banks. In a separate study, King and Levine (1993) show that bank development helps to explain economic growth in a sample of more than 80 countries. Levine (1999) and Levine, Loayza, and Beck (2000) confirm this finding.

The endogenous growth literature also supports the argument that financial development has a positive impact on growth (Bencivenga and Smith 1991). Well-functioning bank-based financial systems are able to mobilise household savings, to allocate resources efficiently, to enhance the flow of liquidity, to reduce information asymmetry and transaction costs, and to provide an alternative to raising funds through individual savings (Bencivenga and Smith, 1991). In the light of these functions, it may confidently be stated that banks have a positive impact on growth.

In Australia, the bank-based segment of the financial sector plays a crucial role in both financial-sector development and economic development. Australia's banks offer a wide range of financial services to individuals and businesses and play an important role in the economy (Australian Bankers' Association, 2013). The banking system ensures the efficient allocation of resources in the Australian economy, through lending to businesses and individuals. Banks facilitate business through the settlement of funds and the provision of credit to

consumers. They provide 24-hour access to funds and facilities, thereby enabling institutions and individuals to save and invest with safety. Additionally, banks in Australia value the communities in which they find themselves and are committed to giving something back to those communities. Every year, community organisations receive millions of dollars of direct support from banks in various forms. The industry also has a strong tradition of free education in financial skills and in 2003 embarked on a major new initiative in financial literacy (Australian Bankers' Association, 2013).

Although Australia has one of the most developed financial sectors in the world, its financial development, as in other developed countries, is largely driven by the market-based segment. Thus the market-based financial segment tends to overshadow its bank-based counterpart. Despite the important role banks play in the economic development of Australia, the Australian banking sector has not received adequate coverage in terms of research. Not much has been documented on the bank-based segment of the financial sector in Australia, except for fragmented policy documents and a couple of papers, which fall short of bringing out a clear picture of such an important segment (Thomson and Abbott, 2000; Merrett, 2002; Neal, 2004; Kirkwood and Nahm, 2006; Hogan and Sharpe, 2007; Gray, 2008). This paper aims to put the Australian banking sector in the limelight – by providing an overview of the country's banking sector, its reforms, growth and challenges since the 1970s and through to 2010.

The rest of this paper is organised as follows: Section 2 gives an overview of the Australian bank-based financial system. Section 3 outlines the reforms implemented to revitalise the banking sector. Section 4 tracks the growth of the Australian banking sector, in response to the reforms. Section 5 highlights the challenges facing the development of the Australian bank-based financial sector. This is followed by the concluding section.

2 An Overview of Bank-Based Financial System in Australia

The Reserve Bank of Australia (RBA) is Australia's central bank. It conducts monetary policy, works to maintain a strong financial system and issues the nation's currency. As well as being a policy-making body, the RBA provides selected banking and registry services to a range of Australian government agencies and to a number of overseas central banks and official institutions. It also manages Australia's gold and foreign exchange reserves (Reserve Bank of Australia, 2013).

The role and functions of the Reserve Bank are underpinned by various pieces of legislation, which includes the Reserve Bank Act 1959, Payment Systems (Regulation) Act 1998, Payment Systems and Netting Act 1998 and Corporations Act 2001. The Bank is a statutory authority, established by an Act of Parliament, the Reserve Bank Act 1959, which gives it specific powers and obligations. In terms of the Act, there are two Boards: the Reserve Bank Board and the Payments System Board (Reserve Bank of Australia, 2013).

The Reserve Bank Board's obligation is to ensure that the monetary and banking policy of the Bank is directed to the greatest advantage of the people of Australia and that the powers of the Bank are exercised in such a manner as to best contribute to the stability of the currency of Australia. The Payments System Board's obligation is to ensure that the Bank's payments system policy is directed to the greatest advantage of the people of Australia, and that the powers of the Bank under the Payment Systems (Regulation) Act 1998 and the Payment Systems and Netting Act 1998 are exercised in a way that will best contribute: to controlling risk in the financial system; to promoting the efficiency of payments system; and to promoting competition in the market for payment services, consistent with the overall stability of the financial system (Reserve Bank of Australia, 2013).

The history of the RBA dates back to as early as 1911 when legislation established the Commonwealth Bank of Australia, which opened for business in mid-1912. With the Federation of the Australian States into the Commonwealth of Australia, the Australian Parliament assumed power to make laws with respect to banking and currency. The first Commonwealth Bank Act, in 1911, gave the Bank only the ordinary functions of commercial and savings banking. The Bank did not specifically have a central banking remit and it operated as both a savings and a trading bank (Merrett, 2002).

In 1924, the Commonwealth Bank Act was amended and the Bank was given control over the note issue. From this time until 1945 – when there were major changes to the legislation – the Bank gradually evolved its central banking activities, initially in response to the pressures of the depression in the early 1930s and later by formal, albeit temporary, expansion of its powers under wartime regulations. These included exchange control and a wide range of controls over the banking system (Reserve Bank of Australia, 2013).

The new Commonwealth Bank Act and the Banking Act, both of 1945, formalised the Bank's powers in relation to the administration of monetary and banking policy, and exchange control. In 1959, the Reserve Bank Act 1959 preserved the original corporate body, under the new name of the Reserve Bank of Australia, specifically to carry on the central banking functions of the Commonwealth Bank, which had evolved over time. The Reserve Bank Act 1959 took effect from 14 January 1960 (Reserve Bank of Australia, 2013).

There were no major changes in the functions of the RBA until the abolition of Exchange Control, following the floating of the Australian dollar in 1983. There had, however, been a gradual movement to market-oriented methods of implementing monetary policy, away from a system of direct controls on banks. In the five years following the appointment of a major financial system inquiry (the Campbell Committee, in 1979), the Australian financial landscape was transformed to a virtually fully deregulated system. At the same time, the RBA gradually built up a specialised banking supervision function (Reserve Bank of Australia, 2013).

Another inquiry into the Australian financial system, the Wallis Committee, was announced in 1996. There were two major outcomes of this inquiry for the Bank, both taking effect from 1 July 1998. The banking supervision function was transferred from the RBA to a newly created authority, the Australian Prudential Regulation Authority (APRA), which was to be responsible for the supervision of all deposit-taking institutions. The Reserve Bank Act was also amended, to create a new Payments System Board, with a mandate to promote the safety and efficiency of the Australian payments system. New legislation – the Payment Systems (Regulation) Act 1998 and the Payment Systems and Netting Act 1998 – was introduced, giving the Bank relevant powers in this area (Reserve Bank of Australia, 2013).

The Australian banking sector comprises banks, credit unions and building societies – known as Authorised Deposit-taking Institutions (ADIs) – that provide the bulk of banking services to Australian households, businesses and governments. These institutions are prudentially regulated by the Australian Prudential Regulation Authority. Non-deposit-taking finance companies also provide competition in selected consumer credit products (Australian Trade Commission, 2011).

Historically, banking in Australia was tightly regulated. Until as recently as the 1980s, it was virtually impossible for a foreign bank to establish branches in Australia (Australian Bankers' Association, 2012). Consequently, Australia had very few banks when compared with such economies as the United States or Hong Kong. Moreover, banks in Australia were divided into two distinct categories, known as savings banks and trading banks. Savings banks paid virtually no interest to their depositors and their lending activities were restricted to providing mortgages. Many of these savings banks were owned by state governments. Trading banks were essentially merchant banks, which did not provide services to the general public. Because of these and numerous other regulatory restrictions on banks, other forms of non-bank financial institutions flourished in Australia, such as the building societies and the credit unions. These were subject to less stringent regulations, and could provide and charge higher interest rates, but were restricted in the range of services they could offer. Above all, they were not allowed to call themselves 'banks' (Australian Bankers' Association, 2012).

According to the Australian Trade Commission (2011, p.9), Australia has a sound, well- capitalised banking sector to date. Its banks are large by global standards, with a strong retail base, highly developed wealth management capabilities, and full-service commercial, trade finance and corporate advisory operations reaching out into the region.

Australia's retail banking sector is highly concentrated, and may be characterised as an oligopoly (Kirkwood and Nahm, 2006, p. 254). There are 65 banks operating in Australia. The four major domestic banks have the largest market shares in the retail and commercial banking sectors. They accounted for 77.49% of resident assets (A$2.4 trillion) as at September 2010. Other domestic banks accounted for 9.2%, while foreign bank subsidiaries and branches accounted for 13.4%. Australia's banking sector offers opportunities for new entrants providing innovative products and distribution systems. Australian banks are increasingly looking to export their expertise in retail banking, funds management, private banking and distribution to the region (Australian Trade Commission, 2011).

While the major Australian banks have dominant market shares across most consumer finance lines, there is also increasing competition from foreign banks, from regional Australian banks and from non-bank lenders (credit unions, building societies and non-deposit-taking specialist finance companies). Foreign banks are also well represented in the Australian market, with 20 of Forbes' top 25 banking institutions having a presence in Australia. The majority of these foreign competitors are focused on commercial banking and capital market activities, although a number of them are now significant players in the retail banking market (Australian Trade Commission, 2011).

According to Bologna (2010), Australian banks were resilient to the global financial crisis, as a result of good fundamentals and a sound prudential and supervisory framework (Bologna, 2010). Banks were not substantially affected by the crisis on the asset side of their balance sheet, with little exposure to U.S. structured credit products and a limited increase in non-performing loans. On the liability side, banks were successful in rolling over most of their short-term debt in international markets, when markets were impaired after the collapse of Lehman Brothers. The authorities' wholesale funding guarantee and liquidity support helped banks to meet their funding needs (Bologna, 2010). The Australian banks, in the context of a sound and effective supervisory environment, are well capitalised and hence well placed to face the forthcoming regulatory changes on capital (Bologna, 2010).

The growth in banks' profits has, however, slowed in recent reporting periods as their bad and

doubtful debt charges have stopped falling, or in some cases, increased. According to the Reserve Bank of Australia (2012), revenue growth has been constrained by modest credit growth and pressures on margins. Even so, aggregate profitability of the banks remains strong. While there is little evidence over the past year that banks have been imprudently easing lending standards in a bid to boost their credit growth, they are seeking ways to sustain the growth in their profitability, including, in some cases, through cost cutting. Such strategies will need to be pursued carefully to ensure that risk management capabilities and controls are maintained (Reserve Bank of Australia, 2012).

The Australian banking sector regulation is split mainly between the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulatory Authority (APRA). ASIC has responsibility for market integrity and consumer protection and the regulation of investment banks and finance companies, while APRA is responsible for the licensing and prudential supervision of ADIs, life and general insurance companies and superannuation funds. These regulators are independent statutory authorities without direct oversight by a government department.

The Australian Bankers' Association (ABA) is also part of the Australian banking landscape. It works with its members – banks – to provide analysis, advice and advocacy, and contributes to the development of public policy on banking and other financial services. The aim of the ABA is to ensure Australian banking customers continue to benefit from a healthy, stable and competitive banking industry.

3 Bank-Based Financial Reforms in Australia

The foundation for financial reforms in Australia was laid some decades ago. According to Grenville (1991), Battellino and McMillian (1989), and Perkins (1989), the financial reform period could be divided into three phases – the first phase being the fully regulated era, which stretched up to the late 1960s; this was followed by the second phase of attempted reform during the 1970s; and thereafter the third phase of the reform, which started during the 1980s.

After the Second World War, the Australian economy was totally protected and regulated for about a quarter of a century. During this period, the Australian Government used its regulatory policies, not only to control the financial system, but also to manage the economy to achieve its desired goals and objectives. For example, during this regulated period, there were direct controls on financial institutions, especially on commercial banks' lending and interest rates. In general, the Australian financial system, until the end of 1970s, was highly regulated (Edirisuriya and O'Brien, 2001).

On the other hand, some other countries, notably the United States, had started to use financial market policies, which were less regulatory. These countries, consequently, discovered the cost of regulation much earlier than Australia. In these cases, the deregulation process started as early as the 1960s. According to Edirisuriya and O'Brien (2001), even though it was apparent that the share of the formal banking sector in the Australian financial system was deteriorating – during this time the non-banking sector was rapidly expanding – nothing happened until the appointment of the Campbell Committee in 1979.

The financial institutions in Australia at the end of the 1980s, a decade after the introduction of financial deregulation, were somewhat turbulent. According to Neal (2004, p.175), deregulation of the banks in the 1980s led to rapid credit growth fuelled by bank lending and the development of an asset-price bubble towards the end of the 1980s. Very tight monetary policy in 1988 and 1989 caused the bubble to burst, and led to some degree of financial instability and a marked weakening of bank balance sheets in the early 1990s.

After implementing the Campbell Committee recommendations, a major structural change emerged in the financial service industry of Australia. During this period, the complexity of the financial markets increased. As a result of this, new challenges to the regulatory system of the country surfaced, giving birth to the Wallis Inquiry (Merrett, 2002).

The Wallis Inquiry was directed to look at almost all the issues confronting the financial system of the country in 1997. The Inquiry was asked to suggest directives to overcome the existing problems, and to find ways of promoting a more efficient and competitive financial system. According to Merrett (2002), the Wallis Inquiry was intended to make a recommendation regarding the creation of a flexible regulatory structure, which would be more responsive to the forces of change operating on the financial system. Edirisuriya and O'Brien (2001) view the findings of the Wallis Inquiry – released in 1997 – as creating a signpost to direct the Australian financial system into the 21st Century. With the publication of this report, significant changes to the financial regulatory structure came into effect on 1 July 1998.

Following a nine-month review process commissioned by the Government in the middle of 1996, Australia commenced reforms to its financial regulatory structure. The Committee of Inquiry, which became known as the 'Wallis Committee', made some 115 recommendations, almost all of which have been subsequently adopted by the Government. The most important of these was the restructuring of the Australian financial sector's many regulatory bodies into just four. The financial regulators now consist of: i) The Australian Competition and Consumer Commission (ACCC) –

responsible for competition; ii) the Australian Securities and Investment Commission (ASIC) – responsible for market conduct and consumer protection; iii) the Australian Prudential Regulation Authority (APRA) – responsible for the prudential regulation of deposit-taking, insurance and superannuation; and iv) the Reserve Bank of Australia – with responsibility for overseeing systemic stability through its influence over monetary conditions, and through its oversight of the payments system.

In Carmichael's (2000) view, although on the surface this appears very similar to structures put in place in the United Kingdom, Japan, Korea and a number of Scandinavian countries, in practice, this system is quite different – and in many ways unique – since it is not based on institutions or products, but rather on regulatory functions.

Another important regulatory development early in the 2000s was the implementation of the Corporate Law Economic Reform Program (CLERP) – which commenced in 1997 and led to the introduction of a number of legislative changes over the subsequent seven years. This was designed to improve the financial infrastructure. Changes included reforms to accounting standard-setting arrangements, audit independence, directors' duties and corporate governance requirements, fundraising and takeover procedures, corporate disclosure requirements, compliance arrangements, provisions for electronic commerce, and shareholders' rights (Davies, 2011).

Further reforms saw the passing of the Financial Services Reform Act in 2001, which took effect on 11 March 2002. This Act gave the ASIC additional responsibility for issues relating to consumer protection and for matters involving foreign exchange contracts, credit and unconscionable conduct. The ACCC retained its administration of consumer protection matters involving health insurance – and for enforcing the competition provisions of the Trade Practices Act in the whole of the financial-service sector (Carmichael, 2000). According to Carmichael (2000, p.13), the role played by the APRA is a very significant one – in changing the financial regulatory environment in Australia. The failure of the HIH Insurance Company in 2001, which was one of the largest insurance companies in the world, had placed substantial pressure on the regulatory system in Australia. As a result, a Royal Commission was appointed by the government, to find out the causes of the failure. The Report of the Commission was published in 2003. Among many recommendations, improvement in prudential supervision by the APRA was a highly significant one (Carmichael, 2000).

In 2006, the RBA set out benchmarks for setting credit- and debit-card interchange procedures for card schemes. The setting of wholesale ('Interchange') fees in the Designated Credit and Debit Card Schemes Standards set out the process for determining a common benchmark for interchange fees in the MasterCard and Visa credit card and debit-card schemes, resulting in interchange rates that were lower than the card scheme rates (Reserve Bank of Australia, 2006).

In a bid to improve competition in the banking sector, the RBA announced further reforms to payment systems – targeting a change in the ATM regime from an indirect charge model to a direct charge model – on 10 December 2008. The reform package came into effect on 3 March 2009 (Reserve Bank of Australia, 2008). This package aimed at delivering significant benefits to consumers, including: making the cost of cash withdrawals more transparent to cardholders and placing downward pressure on the cost of ATM withdrawals; helping to ensure that there would be ongoing widespread availability of ATMs – by creating incentives to deploy ATMs in a wide variety of locations; and thereby providing consumers with choice and convenience. According to the Reserve Bank of Australia (2008), without a change in the current arrangements, the number of ATMs would probably have declined over time, as non-bank deployers found it uneconomic to install and maintain ATMs. Thus, reform promoted competition between financial institutions; and made access less complicated for new entrants, thereby strengthening competition (Reserve Bank of Australia, 2008).

To reassure depositors and investors, and to ensure that Australian authorised deposit-taking institutions (ADIs) were not disadvantaged in their access to wholesale funding markets, relative to banks in other countries, the Australian Government introduced guarantee arrangements for ADI deposits and wholesale funding in October 2008 (Turner, 2011). The Financial Claims Scheme (FCS) provided a guarantee of deposit balances at Australian ADIs, up to a cap that was initially set at $A1 million per depositor per institution, based on the aggregated deposits held in the name of each account-holder. Deposit balances greater than $A1 million, and wholesale funding instruments with a maturity of five years or less were eligible for a temporary government guarantee, for a fee, under a separate Guarantee Scheme (GS) for Large Deposits and Wholesale Funding. In December 2010, the Government confirmed the FCS as a permanent feature of the Australian financial system, and changed the deposit insurance limits to more appropriate post-crisis levels of A$250 000 per person per ADI (Turner, 2011).

In 2011, the Australian financial regulatory authorities further reformed the banking sector. The reforms started with a ban on mortgage exit fees on new home loans from 1 July 2011 – a measure the Australian Banking Reforms (2013) argues would help to boost competition in the home loan market, and would give consumers greater freedom to walk

down the road and get a better deal. From January 2012, lending institutions were compelled by regulation to provide home loan fact-sheets to their customers on request. A fact-sheet provides a standardised layout of information regarding a customer's loan. Because lenders would provide a customer with information in the same way, it would be easier to shop around and compare loans. Through regulation, it has also been made easier to move an everyday transaction account from one financial institution to another. These banking sector reforms stimulated competition among the financial institutions (Australian Banking Reforms, 2013).

In May 2012, the government introduced legislation to amend the Privacy Act (1988) to allow more comprehensive credit reporting. The changes were in response to an earlier Australian Law Reform Commission Inquiry into the application of the Act. In the view of the Reserve Bank of Australia (2012), the reforms aimed to allow credit providers to build a fuller picture of an individual's financial circumstances when determining their eligibility for credit, thereby enabling more accurate assessments of a client's creditworthiness. The reforms also improve consumer protection under the Act, by making it easier for individuals to dispute and correct any errors on their credit file (Reserve Bank of Australia, 2012).

4 Banking Sector Growth in Australia

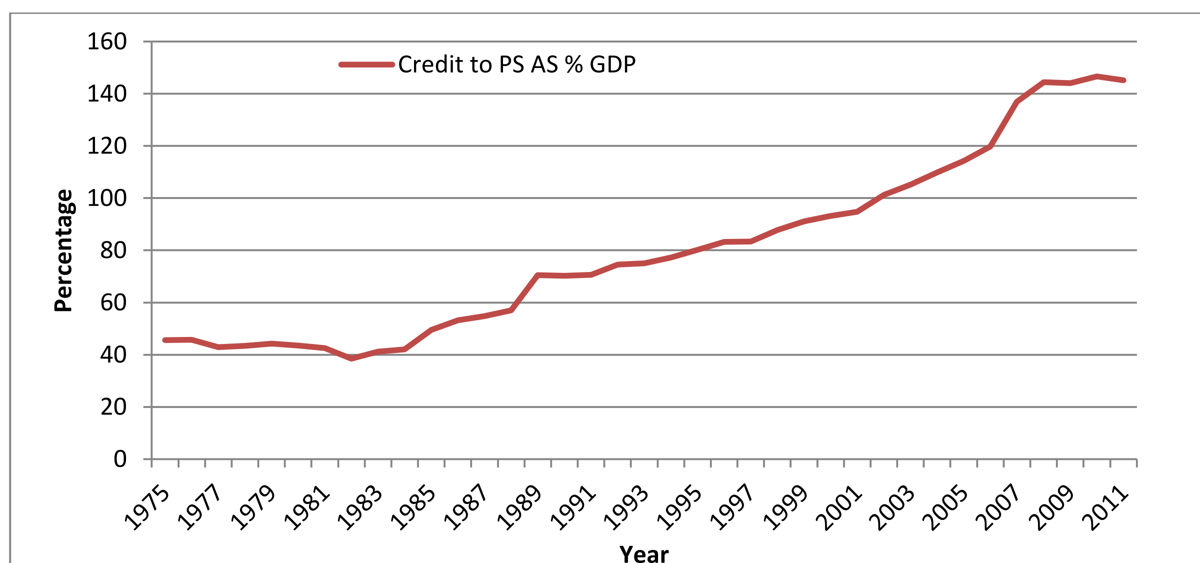
Historically, banking in Australia has been tightly regulated. Until as recently as the 1980s, it was virtually impossible for a foreign bank to establish branches in Australia; consequently, Australia had very few banks when compared with other economies like the United States or Hong Kong. As with many other countries, the great depression brought a string of bank failures. The boom and bust of the 1980s was another turbulent time for banks, with some establishing leading market positions, and others being absorbed by the larger banks (Neal, 2004). The 1990s saw the privatisation of the Commonwealth Bank, and increased competition from non-bank lenders, such as providers of securitised home loans.

Following a string of bank failures, consolidation ensued, as a number of banks were merged, including the takeover of at least one other bank by each of the major banks through the 1990s – by entrenching the already high degree of concentration in Australian banking. According to Neal (2004, p.175), in the latter half of the 1990s, there was pressure from the major banks for further consolidation, with the major banks pressing for the abolition of the 'four pillars' policy – the government ban on a merger between any two of the four major banks. Neal (2004) further lamented that this was partly driven by globalisation and the perceived need for a 'national champion' – a bank that was large enough to compete with other transnational banks on a global scale.

To date, the Australian banking sector has been dominated by four big banks. Competitors of the 'big four' banks include smaller and often regional banks, as well as building societies and mutual credit unions. The number of building societies in Australia is, however, dwindling, as is also the number of credit unions. The APRA put the number of building societies in June 2011 at 10, and the number of credit unions at 103. According to the Australian Bankers' Association (2013), a number of credit unions are adopting the term "bank", in order to overcome any adverse perceptions of smaller deposit-taking entities.

In March 2012, there were 65 banks in Australia (these included Australian-Owned Banks, Foreign Subsidiary Banks, and Branches of Foreign Banks), nine Building Societies and 93 Credit Unions – showing a further reduction in the number of building societies and credit unions from the 2011 figures (Australian Bankers' Association, 2013). The growth of the Australian banking sector is also evidenced by the growth of the private sector credit. In 1975, the credit provided by financial institutions to the private sector was 45.6% of GDP. It, however, remained between 38% and 44% from 1977 to 1984, before increasing to 49.5% in 1985. Thereafter, the Australian private sector credit increased gradually over the years, reaching a peak of 146.6% in 2010 – despite a slight decrease in 2009 in the aftermath of the global financial crisis. In 2011, credit extension to the private sector in Australia was 145.1% of GDP (World Bank, 2012). Figure 1 shows the trends in banking sector growth in Australia during the period 1975 to 2011.

Figure 1. Trends in Banking Sector Growth in Australia (1975-2011)



Source: World Bank Development Indicators (2012)

The non-performing loans in the Australian banking sector, though generally low, have been on the increase since 2006: from 0.2% of total gross loans in 2005 to 0.6% in 2006 and 2007, increasing to 1.3% in 2008, and further increasing to 2% in 2009, and to 2.2% in 2010 and 2011. Australian banks' conservative lending practices, together with robust supervision by the APRA, and the Australian economy's strong performance since the global crisis, have contributed to the low non-performing loan ratio compared with other advanced countries (Jang and Sheridan, 2012). Credit information is relatively easily available to both consumers and banking institutions. Both consumers and institutions have strong legal rights. Table 1 shows some of the banking indicators depicting the development of the Australian banking sector.

Table 1. Growth of Banking Sector in Australia (2000 – 2011)

	Bank Non-performing Loans to Total Gross Loans (%)	Credit Depth of Information Index (0=low to 6=high)	Strength of legal rights index (0=weak to 10=strong)
2000	0.5	-	-
2001	0.6	-	-
2002	0.4	-	-
2003	0.3	-	-
2004	0.2	5	9
2005	0.2	5	9
2006	0.6	5	9
2007	0.6	5	9
2008	1.3	5	9
2009	2.0	5	9
2010	2.2	5	9
2011	2.2	5	9

Source: World Bank Development Indicators (2012)

The growth of the Australian banking sector can also be portrayed by the increasing number of Automated Teller Machines (ATMs). Technological innovations have transformed the Australian financial sector landscape in the past decade, by helping to extend financial services to millions of people. The ATM reforms undertaken by the Australian banking sector during the late 2000s also contributed

significantly to the improved ATM landscape in the country. According to the Australian Payments Clearing Association (2013), there were 30,154 ATMs across Australia in June 2011, an increase of 4.8% or 1,390 ATMs over the previous year. Over the past two years, ATMs have grown by 3,046 or 11%. Only 10 years ago (June 2001), there were 13,289 ATMs. There are now 2.3 times more ATMs than there were 10 years ago (Australian Payments Clearing Association, 2013; Australian Bankers' Association, 2013).

The number of bank branches has also increased for the tenth consecutive year, based on data from the Australian Prudential Regulation Authority (2013). Over the past ten years to 30 June 2011, banks have increased their branch network by 799, or 16.7% to 5,588 branches. The net increase in bank branch numbers has averaged 88 branches per year over the past five years, and 80 per year since the survey began in 2001. The data over the past decade show that the four-year period from 2006 to 2009 saw the number of bank branches increase strongly by 544, an average of 136 branches per year (Australian Bankers' Association, 2013).

5 Challenges Facing Bank-Based Financial Development in Australia

According to IMF (2012a), the Australian banking system was resilient during the global financial crisis. This can be attributed, in part, to intensive supervision and sound regulation; and currently, the banking sector is profitable – with capital being above the regulatory minimums. Despite the IMF's view, the Australian banking sector still faces some challenges. These include bank concentration and exposure.

According to Jang and Sheridan (2012, p.3), banks' main vulnerabilities are their exposure to highly indebted households through residential mortgage lending, together with their sizeable short-term offshore borrowing. Household debt is high, at about 150% of disposable income; but this debt is held mainly by higher income households. Moreover, exposure to high-risk mortgages is small. The potential risks associated with household lending are mitigated by a number of factors – including banks' prudent lending practices and the Australian Prudential Regulation Authority's conservative approach in implementing the Basel II framework, as well as banks' reduction of their use of short-term offshore wholesale funding by increasing deposits and lengthening the tenor of their funding. Nevertheless, short-term external debt remains sizable (Jang and Sheridan, 2012, p.3).

The IMF (2012a) views the concentration and interconnectedness in the Australian banking sector as a challenge. Concentration and interconnectedness mean that idiosyncratic risks could well have a systemic impact. Australia's four major banks hold 80% of the banking assets and 88% of the residential mortgages. The major banks are highly interconnected, as they are among each other's largest counterparties; and their expected default frequencies, from Moody's KMV, are highly correlated (IMF, 2012a). They have grown faster than the banking sector as a whole since the global financial crisis. This is partly due to the acquisition of smaller banks and deleveraging by some foreign-owned banks (Jang and Sheridan, 2012).

According to IMF (2012b), the big four banks share many similarities that could be a cause of risk spreading from one bank to another in the event of a crisis. They are systemically important, which means that difficulties in any one of them would have severe repercussions for the financial system and the economy as a whole (IMF, 2012b). Given their systemic importance, special risk-mitigation arrangements – including more intensive supervision, higher loss absorbency, and robust recovery and resolution plans – would help prevent the failure of major banks. Should such a failure occur, such plans would limit the impact and fiscal costs (IMF, 2012a).

Offshore foreign currency funding is still large, according to IMF (2012b). Australian banks rely on funding from outside the country; and with the crisis in Europe and the global economy suffering, these funding sources are volatile (IMF, 2012b). The turmoil in international financial markets has prompted Australian banks to borrow more domestically. The share of bank bonds issued offshore fell from 78% of the total in 2007 to 60% in 2011. The maturity of offshore bonds has also lengthened, with those maturing in less than a year falling from 80% in 2007 to 56% in 2011.

However, banks' net foreign liabilities, denominated mostly in foreign currency, are still sizeable at 24% of GDP. While almost all foreign currency positions are hedged, in the extreme event that counterparties would fail to deliver, banks might have to obtain foreign currency in the spot market, possibly at unfavourable exchange rates, until they could find a replacement hedge (IMF, 2012a). In addition, the banks could be exposed to rollover risk during such times of stress (IMF, 2012a).

Difficult conditions in the global financial environment may affect banks' overseas asset performance as well, a challenge realised by IMF (2012a). The total foreign claims of the banking system amount to 22% of consolidated assets, of which 6% are cross-border claims. About 40% of these claims are on New Zealand, and a combined 26% are on the UK and Europe, a part of the world that is under financial pressures. According to IMF (2012a), a growth slowdown in New Zealand, which is also a net importer of capital, or an escalation of the sovereign debt crisis in Europe, could impair the quality of banks' overseas assets.

Another challenge is that banks may not see the same level of profitability as that to which they have

become accustomed. Based on the IMF (2012a) assessment, Australian households are saving more, putting an end to two decades of rapid retail credit expansion. In the view of the IMF (2012a), pressure on the net interest margin, which accounts for almost two-thirds of operating income, has the potential to encourage more risk-taking by banks, in order to preserve their profitability.

6 Conclusion

This paper has given an overview of the Australian banking sector; it has highlighted its reforms since the 1980s; it has tracked the growth of the banking sector in response to the reforms implemented over the past five decades; and it has highlighted the challenges currently facing the Australian banking sector. Since the onset of the deregulation era, the Australian Government has implemented a number of reforms, in order to safeguard and improve the banking sector in Australia. These reforms have focused on an improved regulatory structure and surveillance framework, increased risk-management procedures and enhanced corporate governance – in order to strengthen and reposition the banking industry – and to enable it to contribute effectively to the development of the real sector through its intermediation process. In addition, these reforms have also involved a process of substantially improving the financial infrastructure. Although the banking sector has responded positively to some of these reforms, it still faces a number of challenges. These challenges include high bank concentration and exposure to household debt and the Eurozone crisis.

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