2. The Australian Financial System

The Australian banking system remains in a relatively strong position. Wholesale funding cost pressures have diminished in recent months as global market sentiment has improved. The banks have continued to strengthen their capital, funding and liquidity positions, thereby improving their resilience to future shocks or periods of market turbulence. As a result of the strengthening of their capital positions over recent years, the banks are well placed to meet the Basel III minimum capital requirements that the Australian Prudential Regulation Authority (APRA) began phasing in from the start of this year.

Banks' asset performance has continued to improve gradually over recent quarters, even though challenging conditions in parts of the business sector have been contributing to a relatively high inflow of newly impaired loans. While overall asset performance remains weaker than in the years leading up to the global financial crisis, the tightening in banks' lending standards since this time has improved the underlying resilience of their loan books to adverse macroeconomic conditions.

Growth in banks' profits has slowed in recent reporting periods, although aggregate profitability has been strong and is expected to remain so in the period ahead. The slow credit growth environment is likely to encourage banks to implement new strategies to underpin their profit growth over the medium term. To some extent, signs of this are already evident in the greater focus banks have recently given to cost control and in the Asian expansion strategies that some have been pursuing to varying degrees. Of themselves, these strategies need not be detrimental to financial stability – indeed some income diversification among the banks may be beneficial in that respect. However, indiscriminate cost cutting, laxer lending standards or aggressive expansion into unfamiliar markets or products would heighten risks to the banks themselves and potentially also to financial stability.

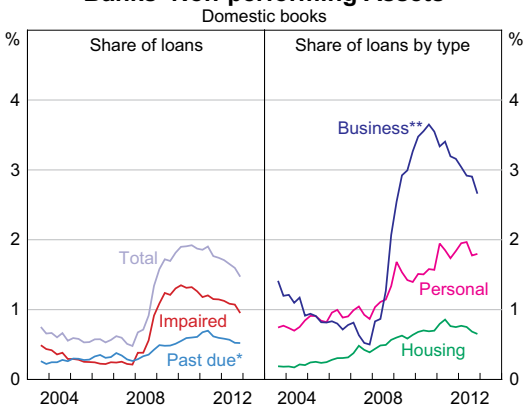
The general insurance industry remains well capitalised and its profitability has strengthened in recent reporting periods, partly because of a more benign catastrophe claims experience. The natural disasters in early 2013 are expected to have only a minor financial impact on insurers.

Domestic Asset Performance

The business models of most Australian banks are heavily focused on lending, particularly in the domestic market. Credit risk is therefore one of the main sources of risk facing the banking system and a key focus of financial stability analysis. The asset performance of the Australian banks deteriorated during the 2008–2009 crisis period and associated economic slowdown, but has been gradually recovering over the past few years.

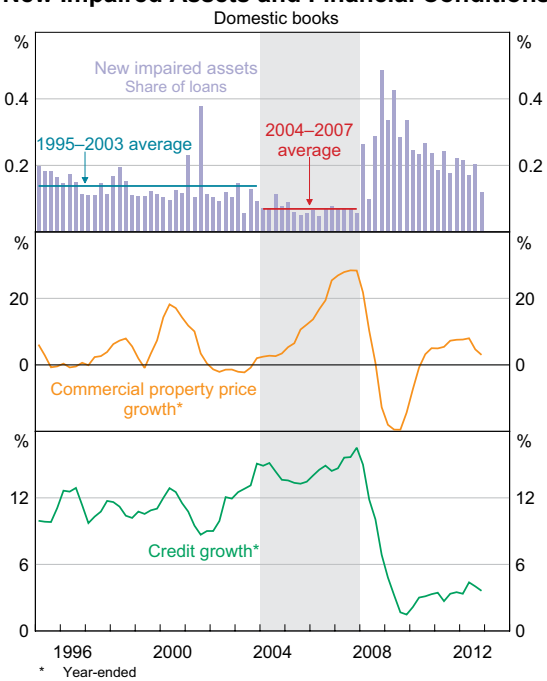
In the banks' domestic portfolio, the ratio of non-performing loans to total loans was 1.5 per cent at December 2012, down from a peak of 1.9 per cent in 2010 (Graph 2.1). The improvement since the peak has been driven by a fall in the share of loans classified as impaired (not well secured and where repayment is doubtful), which also accounted for most of the earlier increase. The share of loans classified as past due (in arrears but well secured) has declined modestly since its peak in 2011, and is currently about half the impaired assets ratio.

Graph 2.1
Banks' Non-performing Assets



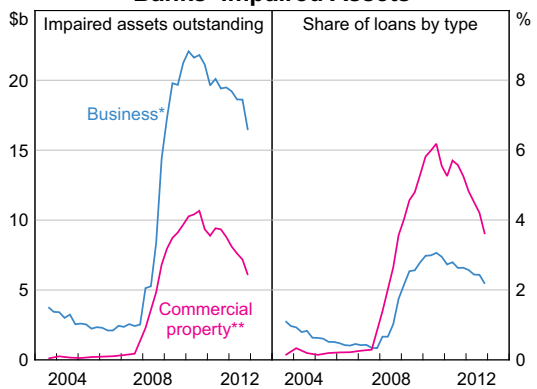
* 90+ days but well secured
** Includes lending to financial businesses, bills, debt securities and other non-household loans
Source: APRA

Graph 2.2
New Impaired Assets and Financial Conditions



* Year-ended
Sources: APRA; Jones Lang LaSalle Research; RBA

Graph 2.3
Banks' Impaired Assets



* Domestic books; all banks; includes lending to financial businesses, bills, debt securities and other non-household loans
** Consolidated Australian operations; sample of 26 banks
Source: APRA

The decline in the banks' impaired assets ratio over the past few years has been sluggish for a number of reasons. These include that banks have generally been dealing with their impaired business loans at a measured pace in order to maximise recoveries as economic and market conditions improve. Accordingly, loan write-offs have been fairly gradual, especially compared with the quick pace that followed the early 1990s recession (when banks' asset quality was also much weaker than today). Another factor is that the inflow of newly impaired loans has been at a relatively high level over recent years (Graph 2.2). While inflows of newly impaired assets were at unusually low levels during the 2004–2007 period, associated with the buoyant asset valuations and credit growth prevailing at that time, average inflows over the past few years have also been above those recorded prior to 2004.

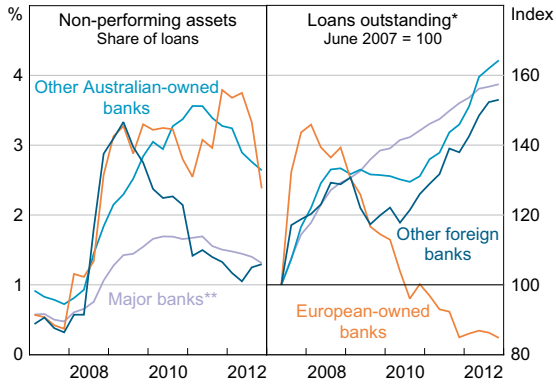
Banks' commercial property exposures have been a key driver of the above-average flow of new impairments over the past few years. Consistent with this, they continue to account for a sizeable share of the impaired assets in banks' domestic business loan portfolios (Graph 2.3). Around 3½ per cent of banks' domestic commercial property exposures were classified as impaired in December 2012, down from a peak of about 6 per cent in mid 2010. The decline in this ratio reflected improved conditions in parts of the commercial property market, but also the disposal of troubled exposures by banks, including some European-owned banks that have been pulling back from the Australian market.

Soft business conditions and profitability in some other industries, as discussed in the 'Business and Household Balance Sheets' chapter, have also contributed to the elevated rate of new loan impairments over recent years, although the performance of banks' domestic non-property business exposures improved modestly over the second half of 2012. Overall, the share of banks' domestic business loans that is impaired has drifted lower, to 2.2 per cent, about 90 basis points below its 2010 peak.

In comparison with banks' business loans, the deterioration in the performance of their housing loans following the 2008–2009 crisis period was fairly mild. The non-performing share of banks' domestic housing loans peaked at 0.9 per cent in mid 2011, and has since declined to 0.7 per cent at December 2012. The recent improvement can be partly explained by lower interest rates and a tightening in mortgage lending standards after 2008; loans originated after this time have performed better than those originated in the preceding few years. Some banks have also strengthened their collections processes in recent years, reducing the time that loans stay in arrears before they are resolved.

The improvement in banks' domestic asset performance over recent quarters has been broad based across the industry (Graph 2.4). Some European-owned banks and smaller Australian-owned banks have recently recorded significant declines in their non-performing business loan ratios, partly due to sales of troubled exposures. Even so, these banks' asset performance remains weaker than that of the major Australian banks. The non-performing share of credit unions and building societies' (CUBS) assets rose slightly over the six months to December 2012, but at 0.5 per cent it remains well below the ratio for banks. While the CUBS' better overall asset performance is partly explained by their higher share of housing loans, the non-performing share of their housing loans is also below that of the banks; former CUBS that have recently converted to mutual banks have similarly low non-performing asset ratios.

Graph 2.4
Banks' Asset Performance and Lending
Domestic books



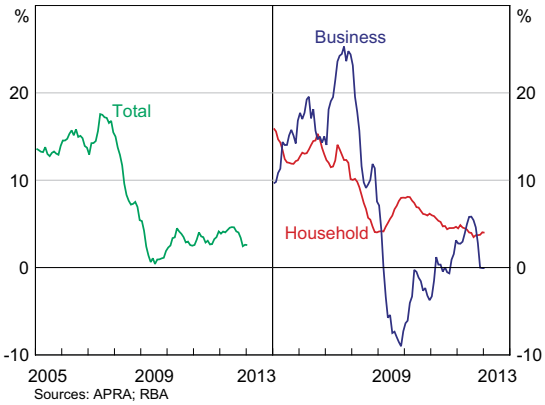
* Data are not break adjusted
** Includes St. George and Bankwest
Source: APRA

According to industry liaison, the continued run-off of troubled exposures that were originated some years ago should exert further downward pressure on banks' non-performing loans. Specific provisions and available security currently cover over 95 per cent of the stock of domestic impaired assets, so (all else equal) these exposures are unlikely to generate further losses for banks unless the underlying asset valuations prove to be unrealistic. In the immediate period ahead, the performance of banks' loans is likely to continue to benefit from below-average interest rates. There is always a risk, though, that economic and financial conditions could deteriorate significantly, which would worsen banks' asset performance. The banks should be less affected by such a scenario than they were in 2008–2009 because the tightening in lending standards has improved the underlying quality of their loan books. Consistent with this, average risk weights on most banks' mortgage and business loan portfolios have declined over the past couple of years.

Credit Conditions and Lending Standards

Growth in banks' domestic loan books remained relatively modest over the past six months (Graph 2. 5). Household credit grew at an annualised rate of about 4 per cent over the six months to

Graph 2.5
Credit Growth
Six-month-ended, annualised



January 2013, as many households have preferred to pay down existing debt rather than take on new debt (see the 'Business and Household Balance Sheets' chapter). Businesses' demand for intermediated debt has also been subdued, with business credit remaining broadly unchanged over the past six months. In addition to deleveraging by some firms, another factor weighing on business credit recently is that some large businesses have raised a greater share of their debt from bond markets, given relatively favourable pricing. While this has reduced banks' lending opportunities, some banks have been looking to shift to fee-paying advisory roles with their corporate clients instead.

Slow credit growth can pressure banks to compete harder to maintain their overall revenue growth. From a risk management perspective, it is important that banks do not respond by imprudently loosening their lending standards. The available evidence suggests this is not occurring at this stage. According to industry liaison, business loan conditions were broadly unchanged over recent quarters. The exception is the 'wholesale' market (i.e. large-value loans), where strong competition amid weak borrower demand has compressed loan margins and, in some instances, eased loan covenants. Some Asian-owned banks seeking to expand their business in Australia are reportedly competing aggressively for syndicated loans, increasing their share of this market noticeably over the past year (Table 2.1). At the same time, a number of European-owned banks have continued to pull back from business lending in Australia, especially syndicated and commercial property lending. This is related to their earlier loan quality problems and difficulties in their home jurisdictions.

In the residential mortgage market, competition for new borrowers has seen some lenders increase interest rate discounts modestly and offer to reimburse refinancing costs or waive application fees. Non-price loan standards, however, appear to have been broadly unchanged over the past six months. As interest rates have fallen below average, a number of banks have recently increased the size of the interest rate buffers they add to their lending rate when assessing borrowers' loan-servicing capacity. This is a prudent approach to ensuring that

Table 2.1: Banks' Business Lending Activity[a]
By ownership, as at December, per cent

	Share of business loans[b]			Share of syndicated loans[c]		
	2007	2011	2012	2007	2011	2012
Australian	80	87	87	40	44	42
Asian	3	5	5	13	18	23
European	14	7	6	36	28	24
Other	2	2	2	11	10	11

(a) Shares might not sum to 100 per cent due to rounding
(b) Bank loans in Australia; non-seasonally and non-break adjusted; excludes securitisations; the purchase of Bankwest by CBA in 2008 contributed to a decline for European banks
(c) RBA estimates; includes offshore banks; mostly loans to non-financial corporations
Sources: APRA; RBA; Thomson Reuters

new borrowers are better able to cope with higher mortgage repayments in a future period of higher interest rates.

Foreign Exposures

While the Australian-owned banks are still predominantly domestically focused, they also have foreign exposures stemming from their overseas operations, as well as the direct cross-border activities of their Australian operations. These foreign activities provide income diversification and other benefits to banks, but they also expose them to various risks and could be a source of strain to the parent bank if conditions deteriorate offshore.

Australian-owned banks' aggregate foreign claims (i.e. exposures) represent a bit over one-fifth of their global consolidated assets, which is a smaller share than for many other large banking systems. These claims are geographically concentrated, with the bulk of them on New Zealand, where the major banks each have large local operations, and the United Kingdom, where NAB also has a large operation (Table 2.2). Claims on the Asian region are smaller, but have grown strongly over recent years. Unlike for New Zealand and the United Kingdom, a significant share of the Australian-owned banks' claims on Asia are cross-border rather than via local operations. This is because their motivation for expanding into Asia has partly been to support their domestic clients' activities in the region and to expand their provision of trade finance there (see 'Box A: Australian Bank Activity in Asia').

The performance of Australian-owned banks' overseas loans has been somewhat weaker than that of their domestic loans in recent years. Banks' overseas non-performing loans were steady over the year to December 2012, although there was a significant divergence in performance across their main overseas markets (Graph 2.6). Loan performance in New Zealand has strengthened as economic conditions there have improved, whereas in the United Kingdom loan performance has been persistently weaker and worsened further over the second half of 2012. This mostly reflects the ongoing difficult economic and property market conditions in the northern part of the United Kingdom where most of NAB's UK exposures are located. By comparison, Australian-owned banks' loan performance in the Asian region has been better, in part because economic conditions in Asia have been reasonably strong, and because a significant portion of their exposures there have a lower credit-risk profile.

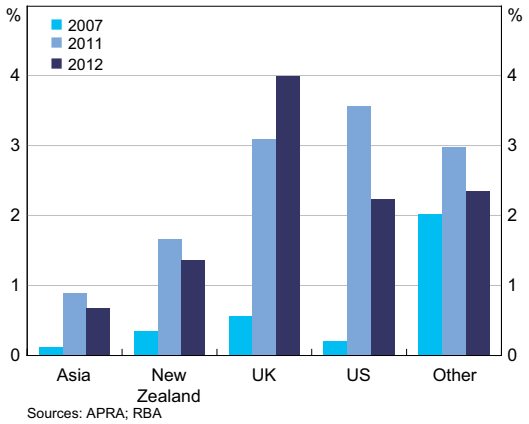
As discussed in 'The Global Financial Environment' chapter, there has recently been rapid growth in residential property prices in a couple of the largest cities in New Zealand. This has been associated with strong competition for new borrowers, particularly in the higher loan-to-valuation ratio segment of the mortgage market. While housing loan portfolios of the Australian banks' subsidiaries in New Zealand are

Table 2.2: Australian-owned Banks' Foreign Claims
Consolidated global operations, immediate borrower basis, per cent

	Share of consolidated assets		Share of foreign claims[(a)]
	Dec 2007	Dec 2012	Dec 2012
New Zealand	10.2	8.2	37
United Kingdom	6.6	4.8	22
Asian region	1.2	3.6	16
United States	2.4	3.1	14
Other countries	2.9	2.6	12
Total	**23.3**	**22.2**	**100**

(a) Shares do not sum to 100 per cent due to rounding
Sources: APRA; RBA

Graph 2.6
Non-performing Assets of Australian-owned Banks' Overseas Operations
Share of loans by region, as at December



Sources: APRA; RBA

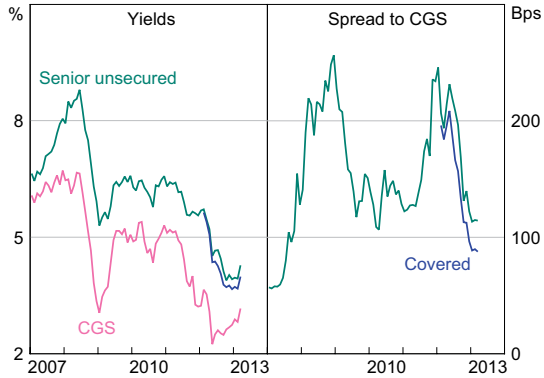
currently performing well, a significant relaxation of their lending standards in pursuit of market share could pose problems once interest rates in New Zealand eventually rise, or in the event of a downturn in economic and property market conditions there.

As discussed in the previous *Review*, the Australian-owned banks have limited direct exposures to the most troubled euro area countries. They are indirectly exposed to these countries via their claims on euro area banks that have substantial direct exposures to the weaker countries, but these claims amount to less than 1 per cent of their consolidated assets.

Funding and Liquidity

International financial and economic conditions can also pose challenges for the liability side of Australian banks' balance sheets, as demonstrated by the periodic bouts of turbulence in global capital markets over recent years and the wholesale funding pressures they created for Australian banks. Wholesale funding conditions have improved for Australian banks since around the middle of 2012 as global market sentiment has recovered (see 'The Global Financial Environment' chapter). Spreads between banks' senior unsecured bonds and Commonwealth Government securities (CGS) have declined by more than 100 basis points over this period, and are now around their lowest levels since the start of the global financial crisis (Graph 2.7). Covered bond spreads have also narrowed sharply since the banks started issuing these types of debt securities in November 2011.

Graph 2.7
Major Banks' Bond Pricing
3–5 year A$ debt

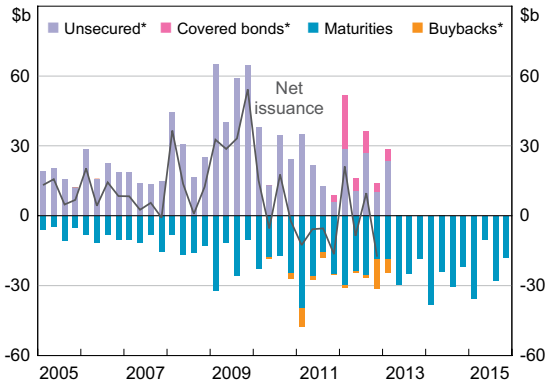


Sources: Bloomberg; RBA; UBS AG, Australia Branch

The Australian banks issued around $40 billion of bonds in the past six months. Over three-quarters of this was in unsecured form, a higher share than in the preceding few quarters when banks issued larger amounts of covered bonds (Graph 2.8). Given that covered bond markets have tended to be more resilient during times of financial market stress, the major banks appear to be spreading out their covered bond issues in a desire to keep some issuance capacity in reserve in case conditions deteriorate again; the banks have currently issued between 20 and 40 per cent of their regulatory capacity for covered bonds. Banks have also taken advantage of the more favourable funding climate by buying back a significant amount of their outstanding government-guaranteed debt, as the cost of new unsecured issuance has become cheaper once the guarantee fee is factored in.[1]

1 For more information, see RBA (2013), 'Box D: Buybacks of Government Guaranteed Securities', *Statement on Monetary Policy*, February, pp 54–55.

Graph 2.8
Banks' Bond Issuance and Maturities
A$ equivalent



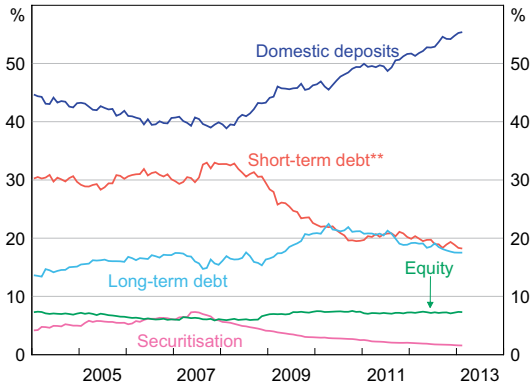
* March 2013 is quarter-to-date
Source: RBA

Conditions in the residential mortgage-backed securities (RMBS) market have also improved over the past six months, with the tightening of spreads for other debt securities helping to entice investors back into the market. Australian financial institutions have issued over $10 billion in RMBS since October 2012; a number of these transactions were priced at spreads around 60 basis points narrower than in early 2012. As a result of strong demand from private sector investors, the Australian Office of Financial Management has not invested in any deals over the past six months. Further momentum in securitisation markets will be relatively beneficial for smaller banks' funding, given that they have less ready access to bond markets than the major banks.

Changes in the composition of the Australian banks' funding over the past few years have left them in a better position to cope with disruptions to funding markets. The share of banks' funding from domestic deposits has increased from about 40 per cent in 2008 to 55 per cent currently; this shift was largely at the expense of short-term wholesale funding, which is typically perceived by markets to be a less stable source of funding (Graph 2.9). The major banks' current funding strategies generally involve rolling over existing term wholesale funding (with zero net issuance) and funding new loans with new deposits on a dollar-for-dollar basis. Banks have been able to achieve this for a couple of years now, with net deposit flows generally exceeding their net credit flows, especially over recent months (Graph 2.10). Currently, banks' deposits are growing at an annual rate of around 9 per cent, well above credit growth of 4 per cent.

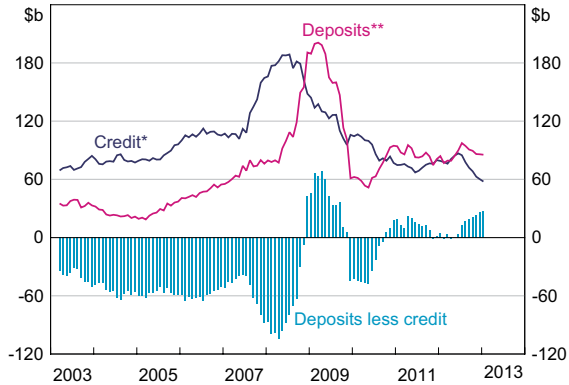
The corollary of the banks' desire to limit their use of wholesale funding is ongoing strong competition for deposits, which has resulted in average spreads on retail deposits remaining around historical highs over the past six months (Graph 2.11). While average spreads on term deposits have declined recently,

Graph 2.9
Banks' Funding*
Share of total



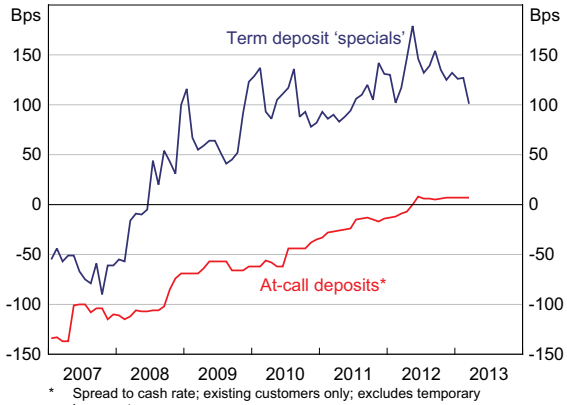
* Adjusted for movements in foreign exchange rates
** Includes deposits and intragroup funding from non-residents
Sources: APRA; RBA; Standard & Poor's

Graph 2.10
Major Banks' Credit and Deposits
Year-ended change in stock



* Excludes securitisations
** Excludes intragroup deposits
Sources: APRA; RBA

Graph 2.11
Major Banks' Deposit Rates
Spreads over money market rates of equivalent maturity

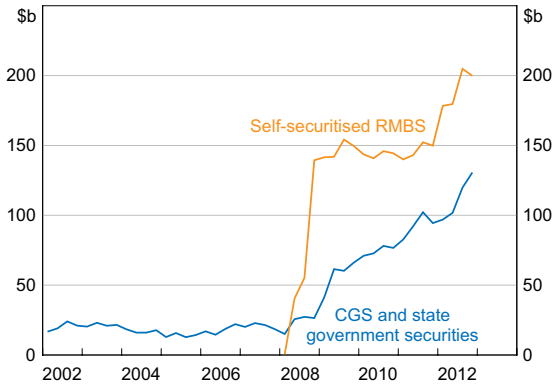


* Spread to cash rate; existing customers only; excludes temporary bonus rates
Sources: Bloomberg; RBA

there has been a marked shift in competition towards some at-call deposit products, such as 'bonus saver accounts'.[2] The major banks generally do not expect overall competition in the retail deposit market to ease materially, at least in the near term, but they are seeking to become more targeted in their deposit strategies ahead of the implementation of the Basel III liquidity standard, such as by adjusting deposit pricing and introducing new products. Indeed, a number of banks have recently begun offering deposit products that require a notice of withdrawal of at least 31 days in advance, as these will receive a more favourable liquidity treatment under the standard.

Banks have also improved their ability to deal with funding stress by increasing their holdings of liquid assets in recent years. These changes are partly a response to the Basel III liquidity standard that will require banks to hold more and higher-quality liquid assets. For Australian dollar-denominated liquid assets, CGS and state government debt will account for the bulk of banks' high-quality liquid assets under the standard. Australian banks currently hold around $130 billion of these securities (equivalent to about 5 per cent of their Australian dollar domestic assets), up from less than $25 billion prior to the global financial crisis (1 per cent of Australian dollar domestic assets) (Graph 2.12). However, given the low amount of government debt in Australia, APRA has adopted elements of the Basel rules that allow banks to count a committed liquidity facility (CLF) provided by the central bank as part of their Basel III liquidity requirements. APRA is in the process of finalising a framework that will ensure banks take all reasonable steps to minimise the CLF's contribution to their liquidity requirements – for example, by lengthening their funding maturities. The banks will be charged an access fee for the CLF, whether or not it is drawn, and it will be secured against assets that are eligible for the Reserve Bank's normal market operations. Self-securitised RMBS will also be able to form part of the collateral for the CLF. Banks' holdings of self-securitised RMBS have increased markedly in recent years, and now total about $200 billion (8 per cent of their Australian dollar domestic assets).

Graph 2.12
Australian Banks' Liquid Assets
Selected A$ liquid assets, consolidated global operations



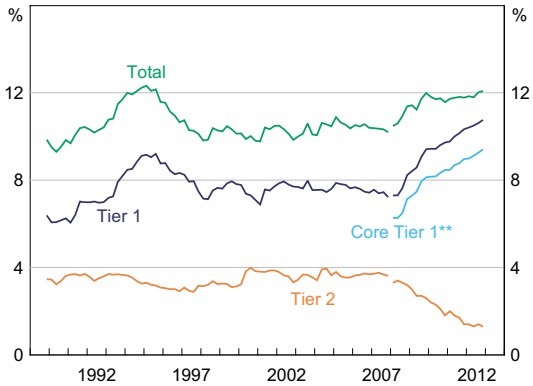
Sources: APRA; RBA

Capital and Profits

The Australian banks have continued to strengthen their capital positions over recent quarters. Their aggregate Tier 1 capital ratio (on a Basel II basis) rose further over the second half of 2012, to 10.8 per cent of risk-weighted assets, up from about 8 per cent in late 2008 (Graph 2.13). Most of the increase in Tier 1 capital over recent years has been through

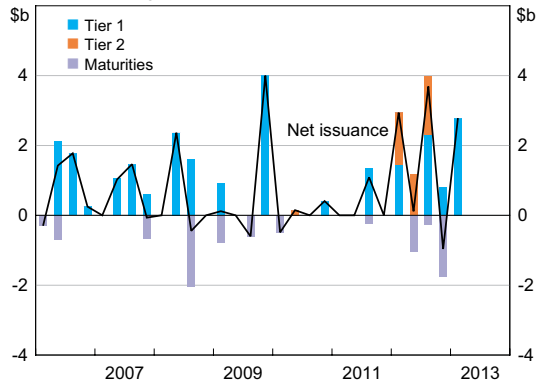
2 For further details, see Robertson B and A Rush (2013), 'Developments in Banks' Funding Costs and Lending Rates', RBA *Bulletin*, March, pp 63–70.

Graph 2.13
Banks' Capital Ratios*
Consolidated global operations



* Per cent of risk-weighted assets; break in March 2008 due to the introduction of Basel II for most banks
** Largely comprises ordinary share capital, reserves and retained earnings
Source: APRA

Graph 2.14
Banks' Hybrid Issuance and Maturities*



* Tier 1 hybrids include convertible preference shares; Tier 2 hybrids include subordinated debt
Sources: RBA; company announcements

earnings retention, given robust profitability over the period, as well as dividend reinvestment programs. CUBS have maintained their higher capital ratios, consistent with their less diversified business models and different corporate structures; their aggregate Tier 1 capital ratio was 15.8 per cent at the end of 2012.

The greater market and regulatory focus on higher-quality Tier 1 capital and the maturity of some Tier 2 capital instruments ineligible under Basel III had seen the banks' aggregate Tier 2 capital ratio decline over the past couple of years, to around 1.3 per cent of risk-weighted assets in December 2012. However, this ratio stabilised over the second half of 2012 due to an increase in Tier 2 hybrid issuance. Since APRA released guidance in May 2012 on what would qualify as non-common equity capital under its Basel III capital standards, banks have issued about $7 billion of Tier 1 and Tier 2 eligible hybrids, equivalent to 0.5 per cent of their risk-weighted assets (Graph 2.14). There has been strong retail participation in these issues, with their relatively high yields in the current low-yield environment attracting investor demand. Hybrids are structured products and some are designed to absorb losses before a bank's common equity has been exhausted; the Australian Securities and Investments Commission has issued warnings to retail investors about the risks associated with holding these instruments and has been reviewing product disclosure statements to ensure the risks are adequately communicated to investors. Overall, the banks' total capital ratio rose by 0.3 percentage points over the second half of 2012, to 12.1 per cent of risk-weighted assets.

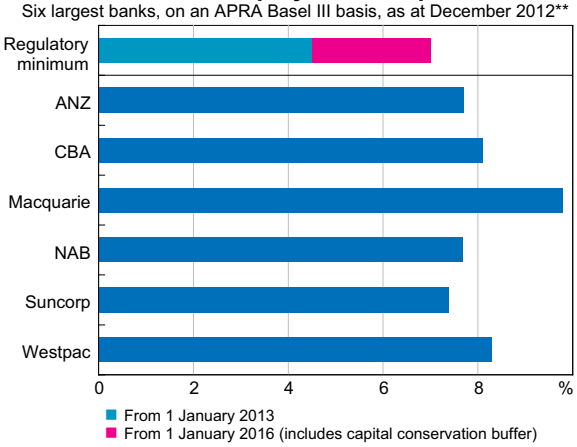
The significant increase in Tier 1 capital over recent years has increased banks' resilience to adverse shocks; recent APRA and International Monetary Fund (IMF) stress tests of the largest banks confirmed that their Tier 1 capital positions (on a Basel II basis) would be sufficient to continue meeting their minimum requirements even in a severe recession that significantly weakened their asset performance.[3] The strengthening of the capital position over recent years has also left the Australian banking system well placed to meet the minimum Basel III capital requirements being phased in from the start of this year. Large banks' public disclosures indicate that their common equity Tier 1 capital ratios on a Basel III basis are currently around 7½ per cent or greater, above the 4½ per cent Basel III minimum that is now required in Australia (Graph 2.15). These ratios also exceed the 7 per cent minimum (including the

3 For information on APRA's stress-test scenario, methodology and results, see Laker J (2012), 'The Australian Banking System Under Stress – Again?', speech to the AB+F Randstad Leaders Lecture 2012, Brisbane, 8 November. Discussion of the IMF stress tests can be found in International Monetary Fund (2012), 'Australia: Financial Stability Assessment', IMF Country Report No 12/308, November.

Graph 2.15

Banks' Common Equity Tier 1 Capital Ratios*

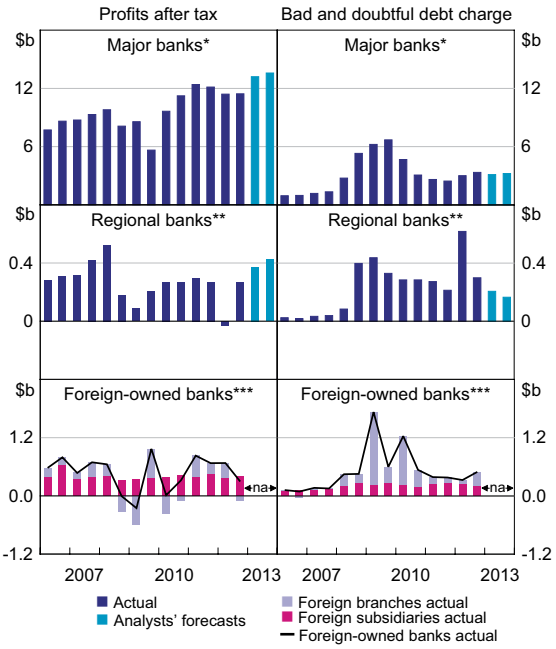
Six largest banks, on an APRA Basel III basis, as at December 2012**



* Banks' estimates; regulatory returns for banks' capital positions under Basel III will commence from the March quarter 2013
** As at September 2012 for Macquarie
Source: banks' financial disclosures

Graph 2.16

Banks' Profit



* ANZ, NAB and Westpac report half year to March and September, while CBA reports to June and December
** Suncorp Bank and Bendigo and Adelaide Bank report half year to June and December, while Bank of Queensland reports to February and August
*** All results are half year to March and September
Sources: APRA; Credit Suisse; Deutsche Bank; Nomura Equity Research; RBA; UBS Securities Australia; banks' annual and interim reports

2½ per cent capital conservation buffer) that the banks are required to meet by 2016. The banks are likely to need to increase their capital ratios further than this, though, in order to provide adequate buffers above minimum regulatory requirements, including for any Pillar 2 or other capital surcharges that APRA may impose due to the risk profile or systemic importance of the banks.[4] Banks should be able to achieve this mainly through earnings retention if current profitability continues in the future.

As noted above, the improvement in the Australian banks' capital positions over recent years has been underpinned by robust profitability; annual return on equity of the four major banks averaged around 15 per cent over 2010–2012. Aggregate profit of these banks was $11 billion in their latest half-yearly results, broadly unchanged from the previous half year, and a little below the peak in 2011 (Graph 2.16). At 5 per cent, income growth over the year was at a similar pace to the previous two years, but higher bad and doubtful debt charges weighed on profits. The performance of NAB's UK loans and, to a lesser extent, each of the major banks' domestic business loans drove the increase in the bad debt charge. To help offset the effect of slow credit growth on their profitability, the banks have been focused on fee-generating and cross-selling opportunities that are less dependent on their balance sheet, as well as improving productivity and reducing costs. Cost-related initiatives announced by the banks include restructuring operations, reducing staff in some areas, and outsourcing certain support functions or moving them to lower-cost locations offshore. It is important that banks ensure that these types of cost-cutting initiatives do not compromise their risk management capabilities and controls.

Looking forward, equity analysts are currently expecting the major banks' profits to rise strongly during the current financial year. With costs expected to continue growing at a slower pace than before the financial crisis and bad and doubtful debt charges

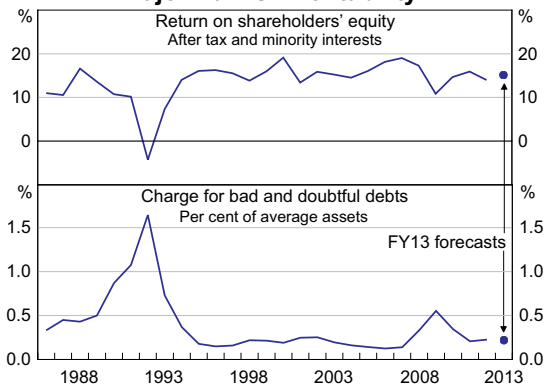
4 For further discussion on banks' capital requirements, see Laker J (2013), 'Financial Regulation and Financial Sector Evolution: Looking Ahead', speech to the Australian Centre for Financial Studies/Finsia Leadership Luncheon Series, Melbourne, 22 March.

expected to level out, analysts are forecasting aggregate annual return on equity to rise to about 15 per cent in the major banks' 2013 financial year (Graph 2.17).

The three regional banks (Suncorp, Bank of Queensland and Bendigo and Adelaide Bank) recorded an aggregate profit of around $270 million in their latest half-yearly results, a recovery from the $30 million loss in the previous half year. This turnaround was driven by an improvement in asset performance which allowed some of these banks to reduce their bad and doubtful debt charges. Asset performance at the regional banks has been poorer than for the major Australian banks, partly because some of them have greater concentrations in Queensland where property market conditions have been weaker. Equity analysts are expecting the regional banks' profits to increase again in the coming year, supported by further declines in bad and doubtful debt charges.

Equity market investors seem to be viewing the Australian-owned banks' financial position and earnings prospects favourably, as banks' share prices have risen by about 25 per cent over the past six months (Graph 2.18). The banks' relatively high dividend yields appear to have been attractive to many investors in the current low interest rate environment.

Graph 2.17
Major Banks' Profitability*



* From 2006 data are on an IFRS basis; prior years are on an AGAAP basis
Sources: Credit Suisse; Deutsche Bank; Nomura Equity Research; RBA; UBS Securities Australia; banks' annual and interim reports

Graph 2.18
Share Prices
1 January 2007 = 100

Sources: Bloomberg; RBA

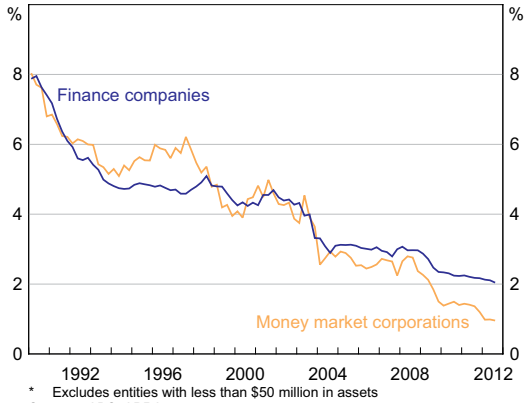
Foreign-owned banks' profits were mixed in their latest half-yearly results. Foreign branches posted an aggregate loss for the half-year, largely owing to an increase in charges for bad and doubtful debts, whereas foreign subsidiaries reported lower charges for bad and doubtful debts and higher profits. Profits of the foreign branches have been volatile over recent years because of losses in their corporate loan portfolios and turbulence in capital markets; foreign subsidiaries' profits have been far more stable given their focus on retail banking.

Registered Financial Corporations

Since the beginning of the global financial crisis, there has been increased interest internationally in assessing the risks posed by the so-called shadow banking system, which can be broadly defined as credit intermediation involving entities and activities outside the prudentially regulated banking system. The Reserve Bank monitors developments in this sector in Australia and provides regular updates to the Council of Financial Regulators. Registered Financial Corporations (RFCs) (comprising money market corporations and finance companies) are the financial institutions most readily considered shadow banking entities in Australia: they are not prudentially regulated by APRA, but they intermediate between lenders and borrowers like banks, and some of them

engage in investment bank-like activities. There are currently over 300 RFCs, but, in aggregate, their share of total domestic financial system assets is small and has been declining over time (Graph 2.19). The significant reduction in this share over recent years can partly be attributed to the more difficult funding conditions RFCs have faced since the 2008–2009 crisis period.

Graph 2.19
Assets of Registered Financial Corporations*
Share of financial system assets



* Excludes entities with less than $50 million in assets
Sources: ABS; APRA

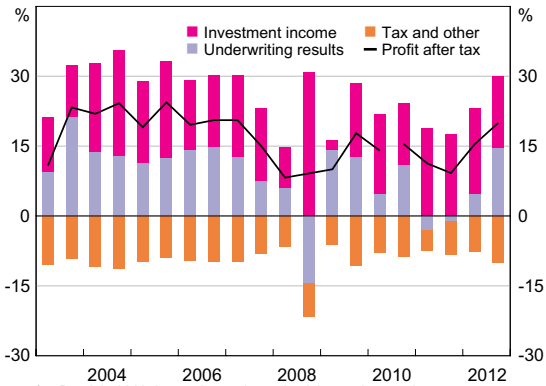
Recently there has been a greater focus on the activities and financial position of finance companies that issue unlisted retail debentures. This follows the collapse of a Victorian retail debenture issuer and property lender Banksia Securities Limited (BSL) in late 2012. BSL was small in size, being only the 28th largest finance company with reported assets of about $690 million. Its failure (and other similar failures of smaller finance companies in recent years) has had no adverse effect on financial system stability, although it has raised investor protection concerns given that many of its investors reportedly had low risk appetites that seem inconsistent with BSL's relatively risky property-related loan portfolio and its thin capital position (see 'Developments in the Financial System Architecture' chapter for more discussion on the regulatory response to this development). More broadly, the RFC sector in Australia poses limited risks to financial stability because of its small size, heterogeneity and minimal credit and funding links to the regulated banking system. For example, RFCs' overall borrowing from, and lending to, banks are each equivalent to less than 1 per cent of banking system assets.

General Insurance

The general insurance industry remains well capitalised at 1.8 times the minimum regulatory capital requirement; the industry's capital position rose modestly over the year to December 2012. APRA introduced revised, more risk-sensitive, capital standards for the general insurance industry at the start of 2013, which are also better aligned with the capital standards for other APRA-regulated industries. The first formal reporting on the level of general insurers' capital under the new standards will be for the March quarter 2013.

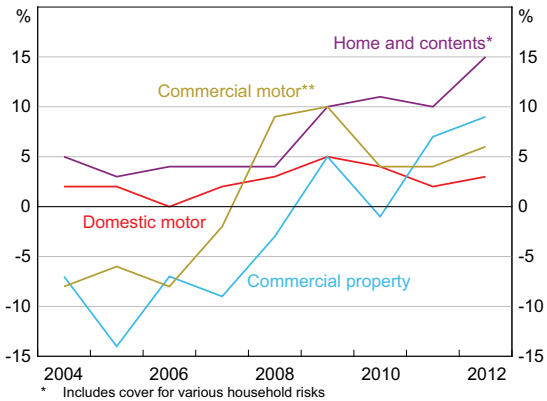
The profitability of general insurers has been strong: annualised return on equity for the industry exceeded 20 per cent in the second half of 2012, up from about 10 per cent in 2011 (Graph 2.20). Strong growth in underwriting profits was driven by rising premium rates for 'short-tail' classes of business, in particular home and contents and commercial property insurance (Graph 2.21). Insurers also benefited from a more favourable catastrophe claims experience in 2012 compared with the previous two years. Although claims are still being assessed, indications

Graph 2.20
General Insurers' Profitability*
Contribution to return on equity, annualised



* Break in 2010 due to change in prudential reporting requirements
Source: APRA

Graph 2.21
Insurers' Short-tail Premium Rates
Year-ended change to June



* Includes cover for various household risks
** Includes Commercial Fire and Industrial Special Risk insurance
Sources: JP Morgan Deloitte General Insurance Industry Survey; JP Morgan Taylor Fry General Insurance Barometer

are that the January 2013 floods and bushfires in parts of Australia will not be severe claims events. The Insurance Council of Australia's current estimate of claims from these disasters is about $1 billion (before reinsurance), well below the $2.4 billion claims arising from the 2011 Queensland floods.

Also boosting insurers' income recently were valuation gains as yields on their holdings of highly rated debt securities declined. However, a prolonged period of low investment yields could present challenges for insurers' profitability. Lower investment returns mean insurers would need to generate more premium revenue to cover future claim payments, particularly for 'long-tail' insurance products such as liability insurance. Competitive pressures and statutory limits appear to be constraining insurers' ability to increase premium rates for most long-tail business lines, although as noted above, premium rates have been rising strongly for some short-tail classes of business. It would be undesirable if insurers responded to premium constraints by shifting the composition of their portfolios towards riskier, higher-yielding assets, although there does not appear to have been a material change in the overall risk profile of investment portfolios at this point. Another concern would be if the insurance industry sought to support short-term profitability through inappropriate releases from reserves; in this regard, APRA has been reviewing reserve practices and adequacy within the industry. No material concerns regarding industry reserving practices have been identified, but it is an area that APRA is continuing to monitor.

Lenders' mortgage insurers (LMIs) offer protection to banks and other lenders against losses on defaulted residential mortgages, in return for an insurance premium that is usually paid by the borrower. Mortgages originated with loan-to-valuation ratios of 80 per cent or greater are typically fully insured in Australia, which is less common internationally. By insuring banks against losses on their higher-risk mortgages, the LMI industry can support financial stability, but the concentration of LMIs' business in correlated risks necessitates strong capitalisation and prudential supervision. The industry is also quite concentrated, with two firms accounting for about three-quarters of industry assets. The LMI industry currently holds about 1½ times the minimum capital requirement which is, in turn, designed to absorb losses from a very severe housing market downturn. While the LMIs are generally highly rated by the major rating agencies, Moody's recently reviewed its global methodology for rating LMIs, which resulted in downgrades in the credit ratings of the two largest LMIs in Australia to low single-A ranges. This reflected Moody's assessment that the LMIs' capital buffers would be tested in the event of a severe economic and property market downturn in Australia (akin to that experienced in the United States over 2007–2011). The downgrades have contributed to some downgrades of ratings on RMBS tranches, given the credit enhancement LMIs provide to these securities, but have not directly affected the LMIs' operations.

The LMI industry's profitability was relatively subdued in 2012. Consistent with the pattern of mortgage arrears for banks, insured mortgages originated in the past few years are performing relatively well, but the LMIs have experienced elevated claims from: loans written in 2007 and 2008; loans to the

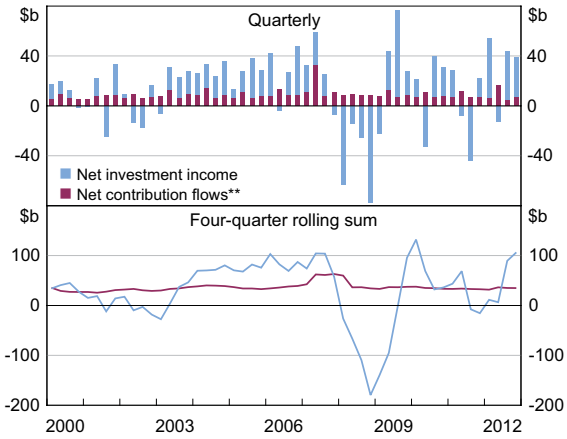
self-employed; and loans for properties in coastal Queensland. Reflecting this, LMIs' loss ratio – claims expense as a share of premium revenue – was a bit above its long-run average in 2012.

Managed Funds

Over the past two decades, banking groups in Australia have acquired a number of life insurers and other funds management businesses, such as those that manage superannuation funds. A number of large life insurers and retail superannuation funds are now owned by or related to banking groups. The wealth management operations of the major banks currently generate about 7–10 per cent of their group profits, and have been a fairly stable source of earnings.

The strong growth in the managed funds sector in Australia over recent decades has been one of the motivations for the banks to diversify into wealth management operations. The managed funds sector currently has about $1.6 trillion in funds under management on a consolidated basis, equivalent to almost 110 per cent of GDP, up from about 55 per cent of GDP two decades ago (Table 2.3). Over the six months to December 2012, assets under management grew by 14 per cent in annualised terms, driven by higher equity prices. Superannuation funds – which account for nearly three-quarters of the managed funds sector – experienced growth of 17 per cent in annualised terms, the strongest rate of growth since the equity market recovery in 2009 (Graph 2.22).

Graph 2.22
Superannuation Funds' Financial Performance*



* From December 2004 excludes entities with less than $50 million in assets
** Total contributions received by funds plus net rollovers minus benefit payments
Source: APRA

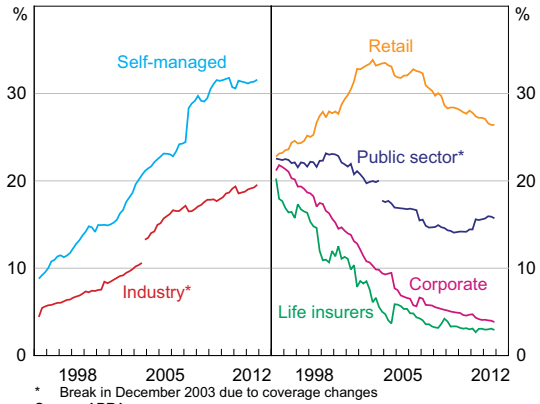
Table 2.3: Assets of Domestic Funds Management Institutions
As at December 2012

	Level	Share of total	Six-month-ended annualised change	
	$ billion	Per cent	Jun 12 Per cent	Dec 12 Per cent
Superannuation funds	1 457	73	12.7	17.0
Life insurers[(a)]	246	12	5.9	9.3
Public unit trusts	264	13	–3.2	2.7
Other managed funds[(b)]	42	2	6.5	1.1
Total (unconsolidated)	**2 010**	**100**	**9.3**	**13.6**
of which:				
Cross investments	406	–	6.6	11.5
Total (consolidated)	**1 604**	**–**	**10.0**	**14.2**

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

Self-managed superannuation funds (SMSFs) have become a significant part of the superannuation industry, with around $470 billion of assets under management as at December 2012. This represents close to one-third of all superannuation assets, a share that has increased by more than 10 percentage points over the past decade (Graph 2.23). Part of the appeal of SMSFs is that they allow people to control their own superannuation investments, although SMSFs are not subject to prudential regulation by APRA and therefore do not benefit from the same protections as APRA-regulated superannuation funds. While borrowing by superannuation funds is generally prohibited, SMSFs are permitted limited use of gearing through non-recourse borrowing. APRA requires banks to take into account the different (and potentially higher) risks posed by SMSF loans when calculating their regulatory capital requirements.

Graph 2.23
Superannuation Assets
By fund type, share of total, unconsolidated

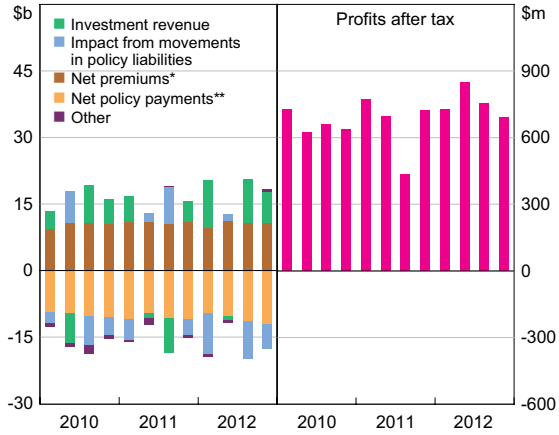


* Break in December 2003 due to coverage changes
Source: APRA

Loans to the superannuation sector have grown strongly in percentage terms over the past several years, but they still account for well under 1 per cent of banks' loan portfolios. Given the limited borrowing from the banking sector at this point, these activities pose limited risks to banks' asset performance. However, there are other important links between the banking and superannuation sectors: superannuation funds have around one-quarter of their funds invested in bank equity and liabilities, and the superannuation operations of banks make a notable contribution to bank profits.

Life insurers' funds under management rose by about 9 per cent in annualised terms over the second half of 2012, driven by strong investment returns from equities and debt securities. Life insurers reported aggregate profits of $1.4 billion in the six months to December, around two-thirds of which was derived from their superannuation business and the remainder from their ordinary life insurance business (Graph 2.24). Profits from their superannuation business were a little above average due to strong investment returns, while profits from their ordinary life insurance business were close to their recent average level.

Graph 2.24
Life Insurers' Financial Performance



* Sum of net policy revenue, premium-related fees and net policy revenue recognised as a deposit
** Sum of net policy expenses and net policy expenses recognised as a withdrawal
Source: APRA

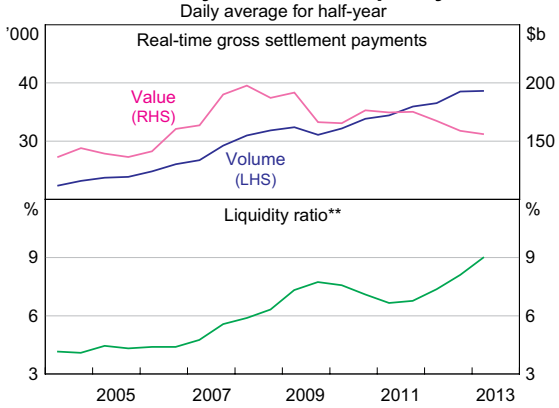
The profitability of the life insurance sector has contributed to its strong capital position over recent years, with the industry holding capital equivalent to 1½ times its capital adequacy requirement as at December 2012. Like general insurers, life insurers are also subject to the revised insurance capital standards that APRA introduced this year; the first data indicating the effect of these standards on life insurers' capital will also be for the March quarter 2013.

Financial Market Infrastructure

Financial market infrastructures (FMIs), such as payment, clearing and settlement systems, are the systems that facilitate most financial transactions and trading activity in the economy. Given the critical services they provide to participants in the financial system, the smooth operation of FMIs is crucial for financial stability.

The Reserve Bank operates Australia's high-value payments settlement system, the Reserve Bank Information and Transfer System (RITS), through which most interbank payments are settled. RITS continued to function smoothly during the past six months, settling around 5 million payments worth $19 trillion. The average daily volume of transactions settled in RITS was steady over the six months to March 2013 (Graph 2.25). In contrast, the average daily value of transactions declined by 4 per cent to $156 billion, around 21 per cent below its peak in the March quarter 2008.

Graph 2.25
RITS Payments and Liquidity*
Daily average for half-year



* March 2013 is six-months-to-date
** Measured as total daily average liquidity over real-time gross settlement payments value as a percentage; RITS liquidity is measured as opening exchange settlement account balances with the RBA and average intraday repurchase agreements with the RBA
Source: RBA

The availability of sufficient liquidity is essential for the smooth operation of RITS. Intraday liquidity in RITS increased substantially over the past year, owing to higher intraday repurchase agreements with the RBA. This increased liquidity has enabled a larger share of transactions to settle earlier in the day relative to the pre-crisis period, helping to reduce potential operational and liquidity risks that could emerge late in the settlement day.

Low-value payments, such as direct entry, consumer electronic (card-based) payments and cheque transactions, are multilaterally netted and settled in RITS in a single batch at 9 am the following day, rather than on a real-time gross settlement basis. In 2010, the Reserve Bank introduced a new system, the Low Value Settlement Service (LVSS), to increase the efficiency of low-value payments settlement. All low-value payment types were successfully migrated to the LVSS by October 2012. The Reserve Bank is working with the industry to implement, for direct entry payments, multilateral settlement at regular intervals on the same day by the end of 2013. This will reduce the credit exposure that can arise when payments are posted to customer accounts ahead of interbank settlement.

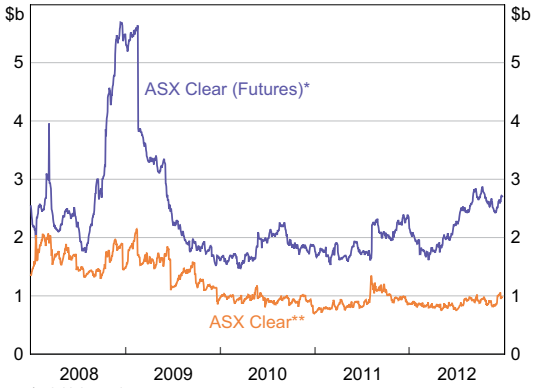
To ensure the safety and stability of the payments system, the Reserve Bank periodically conducts self-assessments of RITS against relevant international principles, which are reviewed by the Payments System Board. The next such review is planned to take place in late 2013.

The two Australian Securities Exchange (ASX) central counterparties, ASX Clear and ASX Clear (Futures), provide centralised management of counterparty risk in the ASX and ASX 24 equities and derivatives markets. From 29 March 2013, the Reserve Bank's revised *Financial Stability Standards* will apply to the two ASX central counterparties (see the 'Developments in the Financial System Architecture' chapter). One important aim of the new standards is to ensure that central counterparties control the risks they pose to the Australian financial system in accordance with international best practice. This includes more granular requirements for the calling of margin from participants and the sufficiency of pooled risk resources held by central counterparties (also known as 'default funds').[5]

5 For details of the enhanced requirements of the new *Financial Stability Standards*, see Reserve Bank of Australia (2012), *New Financial Stability Standards: Final Standards and Regulation Impact Statement*, December.

Margin held at the central counterparties provides an indication of the aggregate risk of open positions held in normal market conditions. Despite a decrease in the volume of derivatives contracts traded over the second half of 2012, margin held on derivatives positions cleared by ASX Clear increased slightly due to an increase in margin rates (Graph 2.26). The increased margin rates reflect a change to ASX Clear's margining system in December, as well as an increase in price volatility for underlying stocks in the resources and financial sectors. Both upward and downward margin rate adjustments were made for derivatives cleared by ASX Clear (Futures) during the second half of 2012. However, increased position-taking by participants coupled with an increase in the margin rate on one actively traded contract resulted in higher margin held overall.

Graph 2.26
Central Counterparty Margins



* Initial margin
** Derivatives initial and mark-to-market margin
Source: ASX