The Australian Financial System

The Australian banking system remains strong having weathered only a very mild downturn compared with international experience over the past few years. The profitability of the largest banks has picked up over the past half-year, reflecting further growth in interest income and a decline in bad and doubtful debt charges. The banking sector's capital position has been bolstered by actions in recent years to increase the level and quality of capital. Banks have also moved to strengthen their funding positions, in an environment where wholesale markets remain sensitive to swings in global investor sentiment. Banks have continued to grow their balance sheets, albeit at a slower pace than in recent years, driven mainly by lending for housing by the major banks.

Profits and Asset Quality of the Banking System

The four major Australian banks reported aggregate headline profits after tax and minority interests of almost $10 billion in their latest available half-yearly results (Table 4). This result was about $1¼ billion higher than in the same period a year earlier and signals a recovery to pre-crisis profitability, following a relatively shallow downturn over the preceding 18 months. In the latest half-yearly results, bad and doubtful debt charges declined markedly – the first decline since the financial crisis began – which drove the recovery in profitability (Graph 25). Interest receipts, which stem from the core lending business of the major banks and

Table 4: Major Banks' Latest Half-yearly Profit Results[(a)]
Consolidated global operations

	2009 $billion	2010 $billion	Change $billion
Income			
Net interest income	22.3	23.1	0.8
Non-interest income	11.4	10.7	–0.7
Expenses			
Operating expenses	15.1	15.7	0.6
Bad and doubtful debts	6.2	4.7	–1.5
Profit			
Net profit before tax	12.3	13.4	1.1
Net profit after tax and minority interests	8.6	9.9	1.3

(a) Half-year to March for ANZ Banking Group, National Australia Bank and Westpac Banking Corporation; half-year to June for Commonwealth Bank of Australia
Sources: Banks' annual and interim reports; RBA

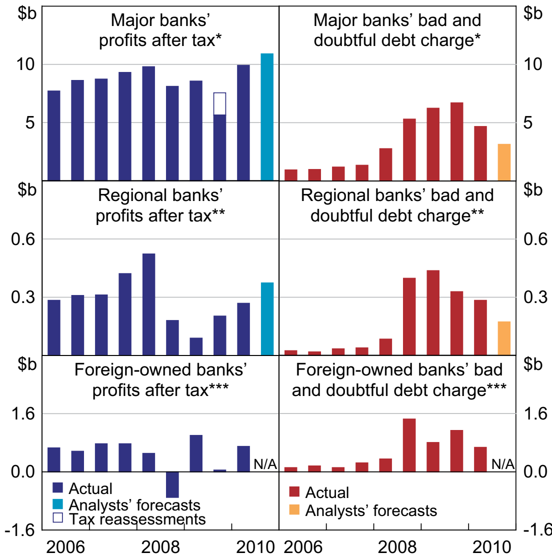
represent their main source of revenue, have been sufficient over the past two years to fully recoup higher funding costs and partly offset the rise in loan losses. Net interest income has therefore continued to underpin the profitability of the major banks, unlike for many of the largest global banks, which had branched out into relying more heavily on trading and investment income. Analysts are forecasting the major banks' bad and doubtful debts to decline further in the near term and their profits to increase commensurately, though some analysts have revised down expectations for growth in net interest income.

Although the smaller Australian banks were more severely affected by the downturn, they have also benefited from improved conditions more recently. Their bad and doubtful debt charges declined by about 15 per cent in the most recent reporting period and profits have increased, although not back to their pre-crisis levels. In aggregate, the regional banks reported $0.3 billion in after-tax profits in their latest available half-yearly results, and market analysts expect profits to increase further in the second half of 2010. Despite an increase of around $0.7 billion in their latest half-yearly results, the profitability of foreign-owned banks in Australia has remained somewhat more variable, with a sharper rise in bad and doubtful debts early in the crisis. However, the cycle has been considerably more muted for these banks as well, when compared with recent overseas outcomes and their historical experience in Australia.

The net interest margin (NIM) of the major banks' consolidated global operations increased by around 20 basis points since the trough in 2008 but has levelled off a little recently (Graph 26). Over the same period, the NIM for their Australian operations is around 35 basis points higher. This divergence reflects that banks have been less successful in recovering increases in their funding costs in overseas markets which have been more adversely affected by the financial crisis than Australia.

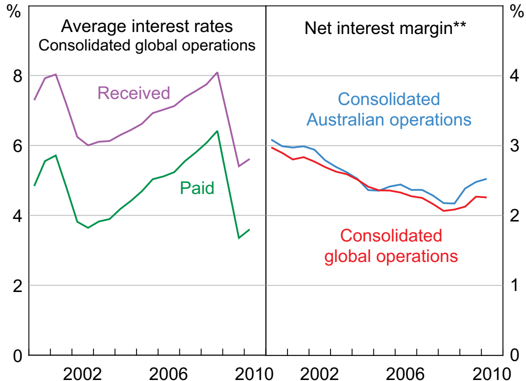
The ability to recoup rising costs and loan losses, which has helped to smooth profits over the past few years, is also reflected in a relatively shallow dip in the major banks' return on equity. The major banks' return on equity recovered from 11 per cent in the 2009 financial year to 14 per cent in 2010 (Graph 27). For the regional banks, results to date suggest that interest income has been somewhat less buoyant because their balance sheet growth remains constrained by their more limited access to funding

Graph 25
Bank Profitability
Institutions operating in Australia



* ANZ, NAB and Westpac report half-yearly to March and September, while CBA reports to June and December
** Suncorp Bank and Bendigo and Adelaide Bank report half-yearly to June and December, while Bank of Queensland reports to February and August
*** All results are half-year to June and December
Sources: APRA; Citigroup; Morgan Stanley; RBA; UBS Securities Australia; banks' annual and interim reports

Graph 26
Interest Rates and Margin*
Major banks



* From 2006 data are on an IFRS basis; prior years are on an AGAAP basis
** Excludes St. George and Bankwest prior to the first half of 2009
Sources: Banks' annual and interim reports

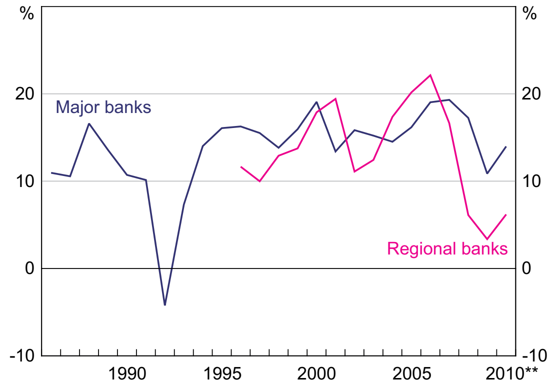
at competitive rates. Compounding the dampening effect this has had on smaller banks' profitability has been the sharper rise in bad and doubtful debts, which in large part stems from earlier lending practices and exposures to problem lending areas such as commercial property. As a result, the return on shareholders' equity has remained below that reported by the major banks, though it is also showing signs of recovery.

As the economic recovery continued in the first half of 2010, the inflow of new impaired assets slowed and more loans have reverted to being no longer impaired (Graph 28). In line with this, write-offs have also declined, banks' provisioning against expected losses on individually identifiable loans has remained little changed, and the charge for bad and doubtful debts is expected to decline further in coming quarters.

Consistent with this, banks' stock of non-performing assets (NPA) rose slightly over the March quarter but remained broadly unchanged at 1.7 per cent of balance sheet assets in the June quarter. This is low compared with many North Atlantic banking systems and below the peak of well over 6 per cent reached in Australia in the early 1990s. Non-performing domestic business assets account for around 60 per cent of the total stock of NPAs, relatively more than domestic business assets' share of total assets.

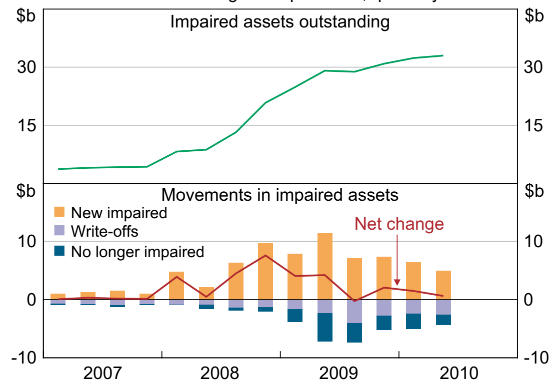
In the overall domestic loan portfolio, the importance of non-performing business assets (at 1½ per cent of all loans) remains much higher than for housing lending (at just ½ per cent) (Graph 29). This is also evident in the much sharper rise in non-performing business assets as a proportion of the business loan portfolio, to stand at around 3½ per cent as at the June quarter 2010, compared with ratios of 1½ per cent for non-performing personal loans and just ¾ per cent for housing loans. The relatively small rise in banks' total domestic NPA ratio over the first half of 2010 reflects that the stock of outstanding business credit is smaller than housing credit and, more recently, that business credit has been broadly flat while housing credit continued to grow, as discussed in the section on 'Lending Growth and Credit Conditions'.

Graph 27
Return on Equity*
Post-tax and minority interests



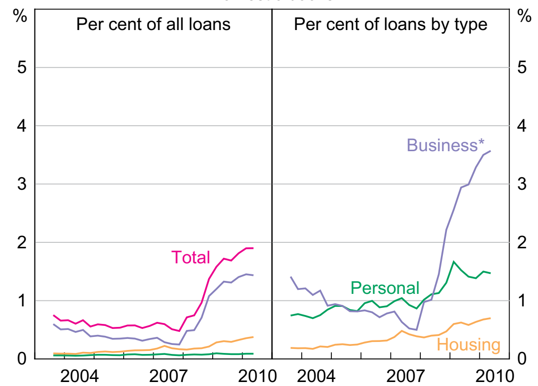
* From 2006 data are on an IFRS basis; prior years are on an AGAAP basis
** 2010 data are annualised half-year results with the exception of CBA, Suncorp and Bendigo and Adelaide Bank
Sources: Banks' annual and interim reports

Graph 28
Banks' Impaired Assets
Consolidated global operations, quarterly



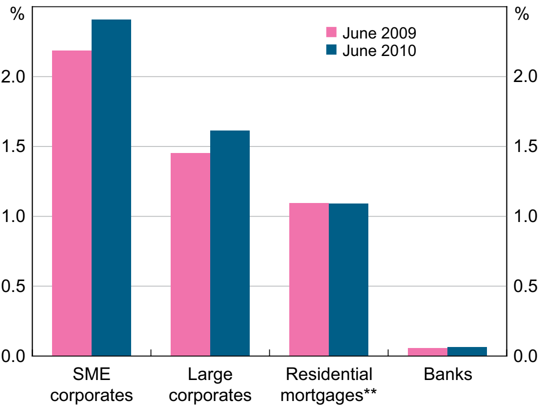
Source: APRA

Graph 29
Banks' Non-performing Assets
Domestic books



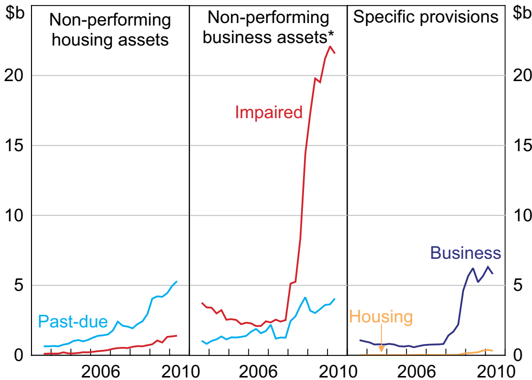
* Includes lending to non-ADI financial businesses, bill acceptances and debt securities, and other non-household loans
Source: APRA

Graph 30
Counterparty Default Probabilities*
Simple average of major banks' estimates



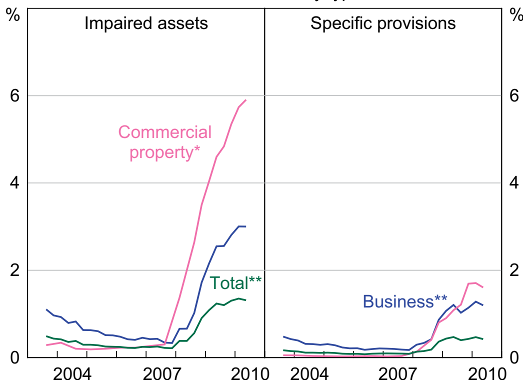
* Consolidated global banking group; on-balance sheet portfolios assessed under the Internal Ratings-Based approach only
** Loans to households and small businesses that are secured by residential mortgages
Source: APRA

Graph 31
Banks' Asset Quality
Domestic books



* Includes lending to non-ADI financial businesses, bill acceptances and debt securities, and other non-household loans
Source: APRA

Graph 32
Banks' Asset Quality
Per cent of loans by type



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

Overall, the major banks' estimated default probabilities for corporate exposures have risen over the past year, partly reflecting expectations about the delayed effects of macroeconomic slowdown – and the unwinding of stimulus measures – on small and medium enterprises (SMEs) (Graph 30).

The dollar value of non-performing business loans might be nearing a peak, as suggested by the stabilisation in the stock of impaired loans and specific provisions (Graph 31). In contrast, the value of non-performing housing assets has continued to rise but remains fairly low. Some of the major banks attributed the increases in early 2010 to rising interest rates, which suggests that their effect outweighed that of the improving labour market. Non-performing housing assets are mainly classed as 'past-due' rather than 'impaired', implying that they continue to be well collateralised – an unsurprising result given house price gains in recent years. Non-performing business assets on the other hand are predominantly 'impaired', so that specific provisions for potential losses on business-related loans are significantly higher than for housing loans. Within the aggregates, impaired assets for the smaller Australian-owned and foreign-owned banks – which had increased much more than at the major banks – have also begun to stabilise.

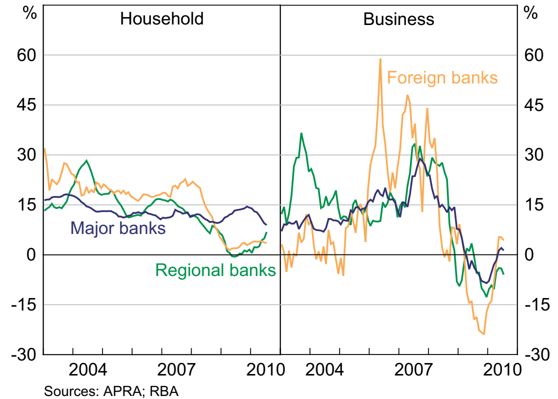
Banks' commercial property exposures remain under the most pressure. Non-performance among loans to this sector (which account for just under one-third of banks' on-balance-sheet business credit) has continued to rise, with the share of loans that are impaired almost double that for all business assets (Graph 32). Part of this increase can be attributed to the run-off in commercial property loan portfolios, since a given value of impairments represents a greater share of a shrinking overall portfolio. Nonetheless, there are signs that these impaired exposures are stabilising, with specific provisions having declined slightly.

In contrast to their domestic assets, banks' overseas assets deteriorated at a slightly faster pace in the first half of 2010 than previously and delinquencies remain higher than on domestic assets. This is

consistent with the weaker economic conditions in the key overseas markets of New Zealand and the United Kingdom, which together make up around 15 per cent of Australian banks' total asset exposures. Despite the ongoing fragility of European financial markets, however, the prospect of contagion spreading directly from banks in countries that use the euro to Australian banks through defaults is limited. The value of Australian bank claims on euro area banks was under $50 billion in March 2010, which is less than 10 per cent of all Australian banks' total foreign claims, 30 per cent of their capital and 2 per cent of their total assets (Table 5). The vast bulk of Australian banks' exposures are to institutions in the larger European countries, and their exposures to the countries that have experienced the most serious financial and fiscal difficulties is small. Since the onset of the financial crisis, the Australian dollar value of exposures to European banks has declined as the exchange rate appreciated against the euro and no net new claims have been established.

Lending Growth and Credit Conditions

Banks continued to expand their provision of credit over the past six months, with housing loans continuing to account for almost all of this growth (Graph 33). This has seen a further increase in the share of housing credit in banks' overall loan portfolio (to around 60 per cent of loans) and a corresponding decline in the share of business credit.



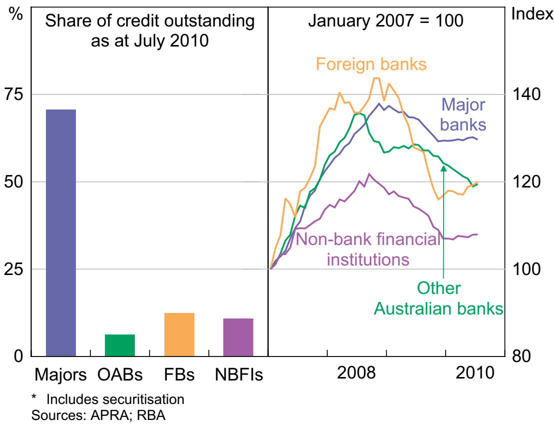
Household credit extended by the major banks (around three-quarters of total household credit) has continued to grow at a faster pace than at other financial institutions, although this has slowed to an annualised rate below 10 per cent amid signs of somewhat softer conditions in the housing market. The deceleration was led by slower lending to owner-occupiers, in line with a decline in loan approvals for first-home buyers as the boost in federal grants to first-home buyers expired, and in part reflecting the return of interest rates to around average levels. Personal credit – a small component of household credit – remained little changed in the past half-year even though margin lending declined.

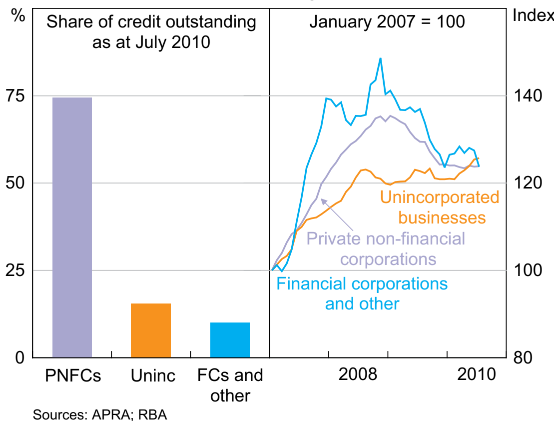
Banks have indicated that the interest rate spreads they are able to earn could come under some

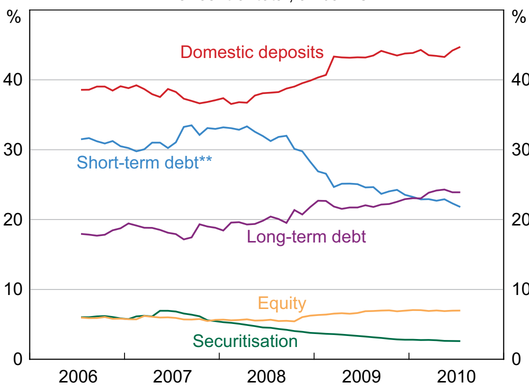
Table 5: Australian Bank Claims on Euro Area Banks
Ultimate risk basis, as at 31 March 2010

	Foreign claims	Share of: Total foreign claims	Total assets	Total capital
	$billion	Per cent	Per cent	Per cent
Greece	0.0	0.0	0.0	0.0
Ireland	1.7	0.3	0.1	1.0
Italy	1.0	0.2	0.0	0.6
Portugal	0.0	0.0	0.0	0.0
Spain	0.8	0.2	0.0	0.5
Euro area	**46.9**	**8.7**	**1.7**	**28.6**

Source: APRA







pressure as cheaper pre-crisis funding is replaced at current market rates, although estimates suggest that at current market yields this would probably have only a marginal effect over the coming year. Margins would also be compressed if the risk spreads on long-term funds were to rise substantially without being passed through to borrowing rates. Banks have shown little sign recently of further tightening non-price lending criteria as an alternative response. Indeed, some banks have recently eased housing lending standards by raising their maximum loan-to-valuation ratios and increasing the discount on some home loans.

In contrast to household credit, total business credit has been broadly flat since late 2009, following a period of contraction, suggesting that the process of corporate deleveraging may be nearing an end. While business credit extended by Australian-owned banks – which accounts for around three quarters of the total – has remained little changed, foreign banks appear to be growing their business loan books again after experiencing a more pronounced contraction in 2009 (Graph 34).

The renewed activity of foreign banks, together with continued improvement in capital markets, has seen competition intensify at the wholesale end of the intermediated business lending market since late 2009. Some banks have eased both price and non-price criteria in this segment, lowering margins and applying less restrictive loan covenants in recent quarters. However, commercial property exposures appear to be an exception to this, with some banks having tightened lending criteria further and others seeking to reduce their exposures by letting existing projects run off in light of the weaker asset quality for the segment (see above). By borrower, credit to private non-financial firms – which accounts for around three quarters of business credit – has been broadly unchanged over 2010 so far, following the period of significant deleveraging in 2009 (Graph 35).

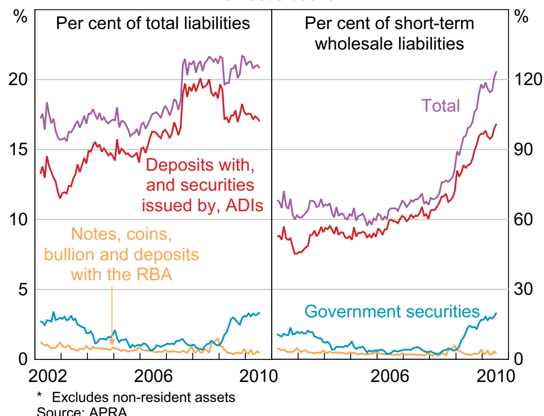
Funding Conditions and Liquidity

The funding position of the Australian banking system has strengthened in recent years, with less use of short-term finance and greater holdings of liquid assets. Banks have continued to access key funding markets after the Guarantee on Large Deposits and Wholesale Funding closed to new issuance in March, although the experiences of the major and smaller banks differ somewhat. Issuance has been at risk spreads considerably narrower than those prevailing in 2008 and early 2009. Risk spreads remain wider than during the pre-crisis period, although that was a period when risk, globally, was probably being underpriced.

In addressing liquidity risk, banks have in recent years been particularly focused on reducing reliance on short-term wholesale funding. Reflecting this, short-term wholesale debt as a share of total bank funding has fallen from around a third in 2006 to around a quarter, replaced by long-term wholesale debt and deposit funding sources typically regarded as more stable (Graph 36). Banks have also increased their holdings of liquid assets – such as cash, deposits and highly marketable securities – as a share of banks' total domestic liabilities. Liquid asset holdings remain well above pre-crisis levels (Graph 37). A larger share of liquid assets than before is now held as government securities, although the outstanding stock of these is much too small for Australian banks to meet the proposed international guidelines on liquidity management using government securities alone. As a result, alternative arrangements for Australia to meet the guidelines are currently being developed (see the chapter on 'Developments in the Financial System Architecture'). The ratio of liquid assets to short-term wholesale liabilities has continued to increase sharply as the latter have declined.

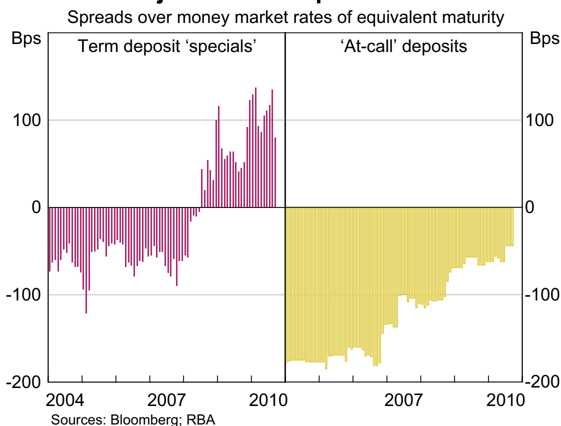
Growth in deposits in recent years has been fuelled by strong competition among authorised deposit-taking institutions (ADIs). In recent months, deposit rates have been at or around historically high spreads to money market rates, particularly for 'special' term deposit rates (Graph 38). Nevertheless, aggregate

Graph 37
Banks' Liquid Assets*



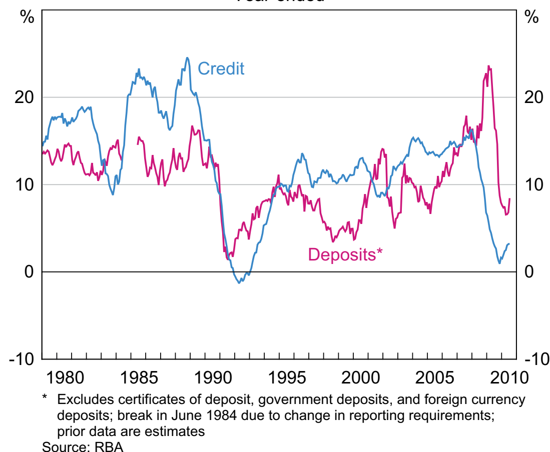
* Excludes non-resident assets
Source: APRA

Graph 38
Major Banks' Deposit Rates

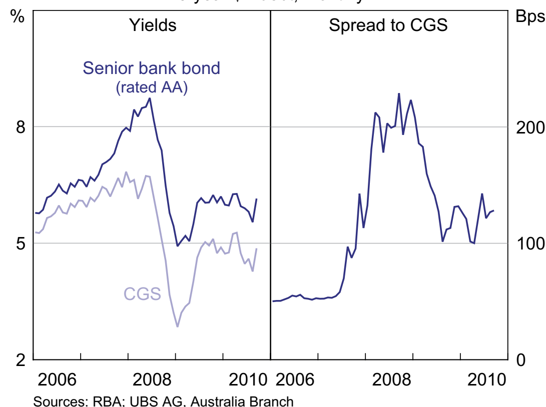


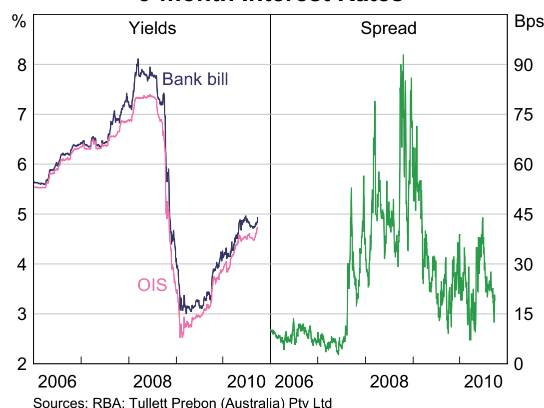
Sources: Bloomberg; RBA

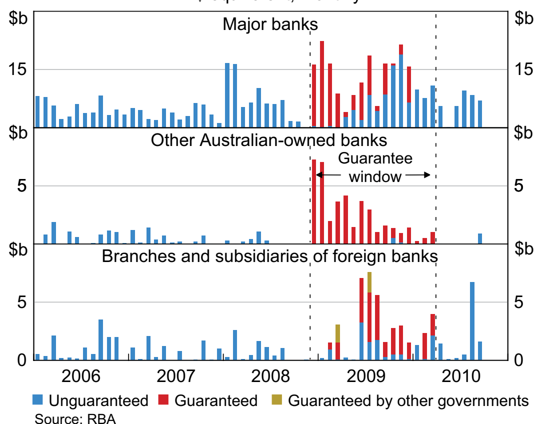
Graph 39
Credit and Deposit Growth



* Excludes certificates of deposit, government deposits, and foreign currency deposits; break in June 1984 due to change in reporting requirements; prior data are estimates
Source: RBA







deposit growth remains well below the rates of late 2008 and early 2009, consistent with the slower rate of credit growth (Graph 39). Given the increases in deposit rates relative to wholesale rates – and the free government guarantee for deposits of $1 million and under through the Financial Claims Scheme – some of the growth in deposits in recent years is likely to be replacing funding previously obtained through short-term wholesale instruments.

After improving significantly over the first half of 2009, conditions in both domestic and offshore long-term bank debt markets have stabilised somewhat. The major banks' domestic three-year bonds, for instance, have traded within a range of 100 to 145 basis points over Commonwealth Government Securities (CGS) since the middle of 2009, compared to around 200 basis points for most of 2008 (Graph 40). Spreads on three-month bank bills to the three-month overnight swap rate (OIS) have remained volatile over the past year or so, trading within a range of 5 to 45 basis points (Graph 41). This compares to spreads of over 90 basis points during the height of the crisis. The pricing of bank debt remains influenced by international developments and was noticeably affected as concerns about the fragility of the European financial sector resurfaced earlier this year.

In line with slower credit growth and significant earlier pre-funding, the rate of Australian bank bond issuance has slowed in 2010, from the very strong pace of 2009 when the guarantee scheme for wholesale funding was in operation (Graph 42). The major banks held back from large-scale issuance of long-term debt when concerns around European sovereign debt escalated in April and May, though issuance has picked up again since that time.

A number of smaller institutions had made considerable use of the wholesale funding guarantee, as difficult conditions curtailed the funding previously available through securitisation in the form of residential mortgage-backed securities (RMBS) (Graph 43). Conditions in RMBS markets have improved but are still challenging, with secondary

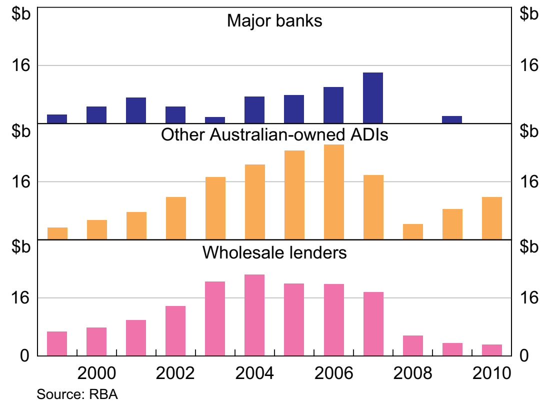
market spreads on AAA-rated RMBS tranches having remained at around 140 basis points above the three-month bank bill swap rate since March. Smaller institutions have accounted for the bulk of issuance over the past six months, with the support of the Australian Office of Financial Management (AOFM). The AOFM has purchased around one quarter of RMBS issuance in 2010 to date, compared with almost half of all issuance in the period from when the program commenced to the end of 2009. The AOFM's holdings now represent around 10 per cent of all RMBS outstanding, or around 15 per cent of the total domestic market. No losses have been borne by investors in a rated tranche of an Australian prime RMBS. Credit enhancements such as lenders' mortgage insurance continue to fully cover any losses on prime RMBS (after proceeds from property sales).

Conditions in the shorter-term securitisation markets remain particularly subdued. The amount of asset-backed commercial paper (ABCP) outstanding has continued to decline, reflecting the ongoing amortisation of existing loan pools (i.e. loan repayments), as well as some reduction in the supply of assets typically funded by ABCP, such as lending by mortgage originators (Graph 44). However, market participants report that they continue to have little difficulty rolling over paper, and ABCP spreads have fallen noticeably, to be around 30 basis points above the one-month bank bill swap rate (BBSW).

Capital and Financial Markets' Assessment

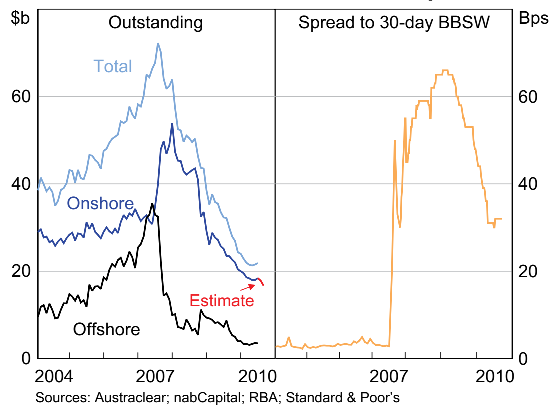
The Australian banking system maintains its strong capital position. The Tier 1 capital ratio is currently around 9½ per cent, well above the regulatory minimum of 4 per cent (Graph 45). The credit union and building society sectors are also well capitalised, with aggregate total capital ratios of around 16 per cent. Ordinary share capital has increased a little in the past six months, mostly through dividend reinvestment plans (Graph 46). As a result, ordinary

Graph 43
RMBS Issuance



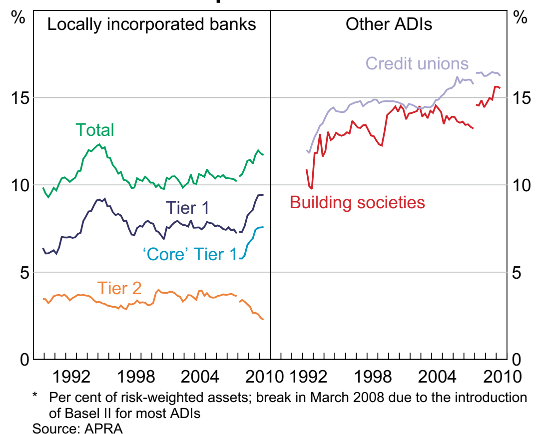
Source: RBA

Graph 44
Asset-backed Commercial Paper



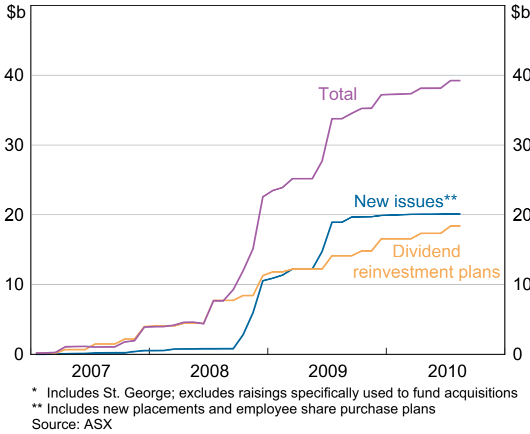
Sources: Austraclear; nabCapital; RBA; Standard & Poor's

Graph 45
Capital Ratios*



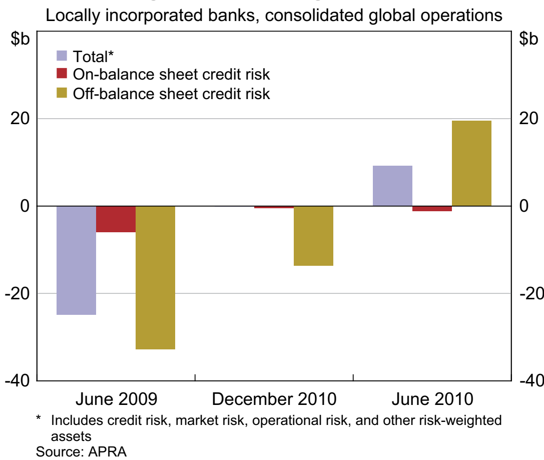
* Per cent of risk-weighted assets; break in March 2008 due to the introduction of Basel II for most ADIs
Source: APRA

Graph 46
Major Banks' Equity Raisings*
Cumulative from 1 January 2007



* Includes St. George; excludes raisings specifically used to fund acquisitions
** Includes new placements and employee share purchase plans
Source: ASX

Graph 47
Change in Risk-weighted Assets
Locally incorporated banks, consolidated global operations



* Includes credit risk, market risk, operational risk, and other risk-weighted assets
Source: APRA

share capital represents more than two thirds of total net capital for the banking system. The available data for the September quarter suggest that the phase of rising bank capital buffers may have run its course for the time being. The major banks raised little new equity during the past two quarters and have all increased dividends paid out to shareholders.

In recent years, banks have focused on bolstering their Tier 1 capital, and in particular their 'core' capital (mainly common equity), while allowing their Tier 2 capital to decline. Since Tier 1 capital absorbs losses while a bank continues to operate as a 'going concern', Tier 2 capital (mainly subordinated debt) is becoming less relevant for financial stability as it is generally only available to absorb losses on a 'gone concern' basis, that is, in a wind-up.[2]

An important feature of the recent market downturn in Australia was that most credit losses were small enough to be absorbed by banks' revenue and modest when compared with the buffer of capital. Furthermore, the quality of capital held by Australian banks appears to compare favourably with banks in other countries. The Australian Prudential Regulation Authority (APRA) recently subjected the 20 largest ADIs to a very severe three-year macroeconomic stress test, and found the adequacy of capital to be resilient, with no institution failing or breaching the minimum 4 per cent floor in Tier 1 capital ratios under the scenario.[3] The scenario assumed that macroeconomic conditions and asset prices deteriorated by more than in overseas scenarios, so bad and doubtful debt charges rose quite sharply; the largest banks also suffered from the pro-cyclicality inherent in rating migrations of risk-weighted assets.

Following a period of generalised risk retrenchment, the risk-weighted assets of banks increased in the first half of the year (Graph 47). The rise was driven by off-balance sheet credit exposures, which comprise commitments, credit guarantees, letters of credit and other contingent facilities.[4] The increase was partly related to a change in the methodology used to calculate risk-weighted assets for some portfolios.[5] The rise may also be related to corporates repaying

2 See also Gorajek and Turner (2010), 'Australian Bank Capital and the Regulatory Framework', RBA *Bulletin*, September.

3 John Laker (2010), 'The Australian Banking System under Stress?', speech to Australian Business Economists, 9 June.

4 These exposures are off-balance sheet because at the balance sheet date they are contingent. Once the contingent event occurs, the item moves onto the balance sheet as an asset.

5 In particular, some portfolios were migrated from the Standardised approach to the Internal Ratings-based (IRB) approach to calculating regulatory capital. Under the Standardised approach banks use a prescribed set of risk weights, while under the IRB approach banks are authorised to use their own models to determine the key inputs in the credit risk calculation.

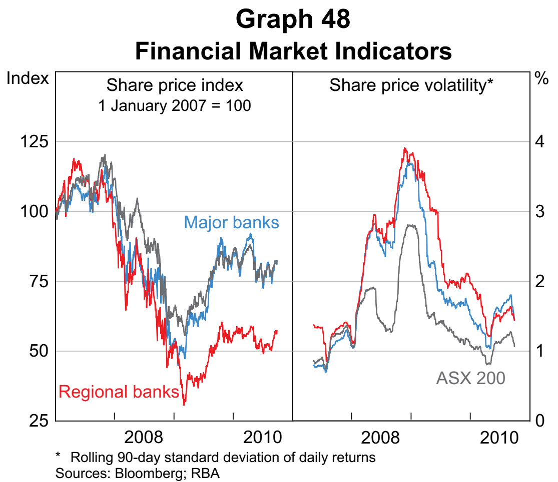
credit lines previously drawn upon. As corporates deleverage and repayments are made on credit lines, on-balance sheet amounts decline and available off-balance sheet facilities increase. In contrast, on-balance sheet credit risk-weighted assets, which comprise about 70 per cent of the total, remained little changed, possibly reflecting that new lending and draw-downs offset any repayments of credit lines. Average risk-weights for loans applied by the major banks remained fairly steady during the period and exposures to market and operational risks continue to be modest.

After experiencing a strong rebound during 2009, Australian bank share prices have remained in a range for the past three quarters (Graph 48). However, there has been some variability in line with developments in Australian and offshore markets. Analysts generally remain upbeat about the Australian banking sector given recent profit results, but some remain cautious about the potential for further slowing in credit growth and the implications for short-term earnings.

Investors' concerns about euro area sovereign debt, along with doubts about the global economic recovery, were reflected in an increase in share price volatility around the middle of the year. Despite this increase, volatility remains significantly lower than during the most stressed periods in the crisis. Some uncertainty has also been reflected in a moderate increase in Australian banks' credit default swaps (CDS) premia – the price paid by investors to insure against default on bank debt – though no more than was seen abroad.

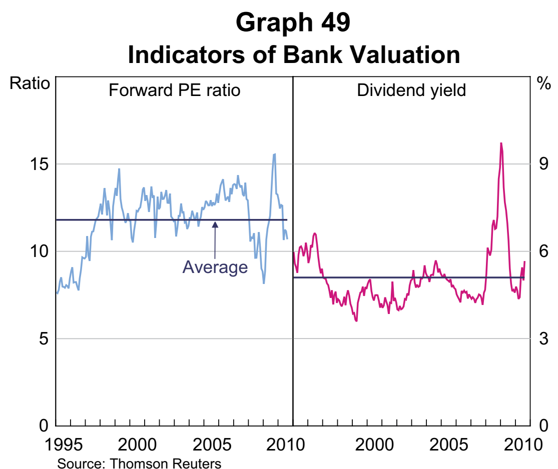
Market-based valuation measures are closer to their long-term averages than in recent years (Graph 49). After a strong increase during 2009, driven by higher share prices, the forward price-to-earnings (PE) ratio has declined as the outlook for earnings improved and share prices stopped rising. Similarly, the dividend yield – the amount paid out in dividends relative to the share price – has increased during the year as banks have increased their dividend payments.

Graph 48
Financial Market Indicators



* Rolling 90-day standard deviation of daily returns
Sources: Bloomberg; RBA

Graph 49
Indicators of Bank Valuation

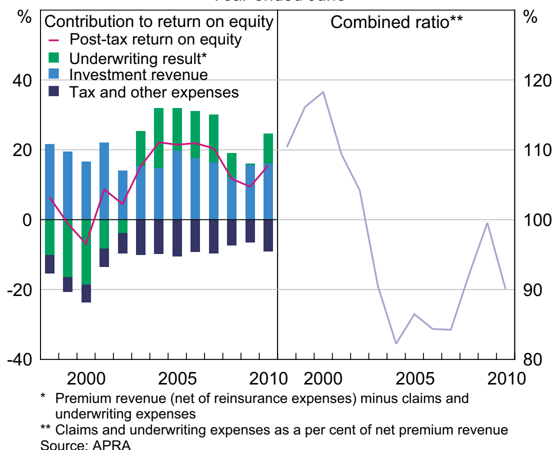


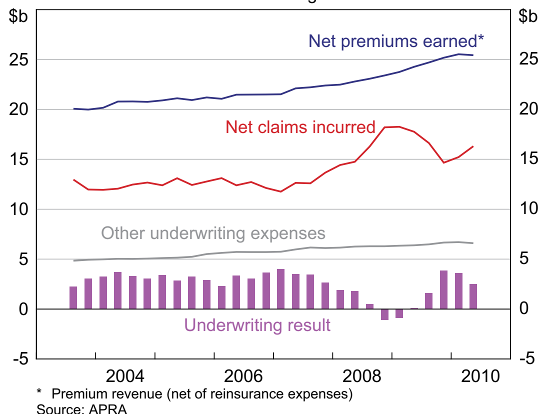
Source: Thomson Reuters

The major banks remain highly rated by international credit rating agencies. Using Standard & Poor's ratings, the major banks are AA-rated, while the other Australian banks are ranked between upper-medium and lower-medium investment grade. Recently, Standard & Poor's revised up the outlook from 'negative' to 'positive' for HSBC Bank Australia. Standard & Poor's outlook for Australian banks is largely stable, based on expectations of sound macroeconomic conditions, strong earnings and conservative lending standards.

General Insurance

The Australian insurance industry reported strong profits in the latest year. Post-tax profits were $4.6 billion in the year to June 2010, up from $2.6 billion in the previous year, and reflecting this the industry's return on equity was 16 per cent in the latest year, broadly in line with the average over the past decade (Graph 50). This result was driven by improved underwriting conditions. Insurers' aggregate combined ratio – claims and underwriting expenses relative to net premium revenue – fell to 90 per cent in 2010, which is more in line with the ratio between 2003 and 2006.





The strong underwriting result in the latest year was due to both higher premium revenue and a fall in claim expenses, though these trends show signs of turning in the latest quarter or so (Graph 51). The rise in revenue was largely attributable to continued premium rate increases (particularly within some personal lines), albeit at a slower pace than in earlier years – the insurance services consumer price index (CPI) shows that the cost of insurance to consumers increased by around 5 per cent over the year to June 2010. In addition, there were some signs that more households were taking out insurance policies in the latest year, mainly in response to recent severe weather events.

The latest annual decline in claim expenses was largely a reversal of the elevated claim expenses in the 2008/09 financial year that resulted from a sharp fall in government bond yields used to discount expected future claims. Despite the fall, claim expenses in the latest year were still above the average over the decade and the latest quarterly data show them drifting up again. One reason for this was the effect of severe weather events, particularly in the half-year to June 2010. These included the Melbourne and Perth storms in March 2010, which are estimated to have caused around $2 billion in insured losses. In the period ahead, the Australian insurance industry is likely to incur claims relating to the recent Victorian floods and the New Zealand earthquake. It is unlikely, however, that the New Zealand earthquake will result in significant claims, as the Australian insurance industry is not significantly exposed to New Zealand.

In addition to the positive annual underwriting result, income from investments increased by $0.5 billion to around $5 billion over the year to June 2010. The increase was largely due to a rise in prices on fixed-income securities, as government bond yields fell in the half-year to June 2010, and this offset lower interest income. Investment income was not greatly affected by the disruption to equity markets in 2010, as equities only accounted for around 5 per cent of general insurers' investment assets at June 2010.

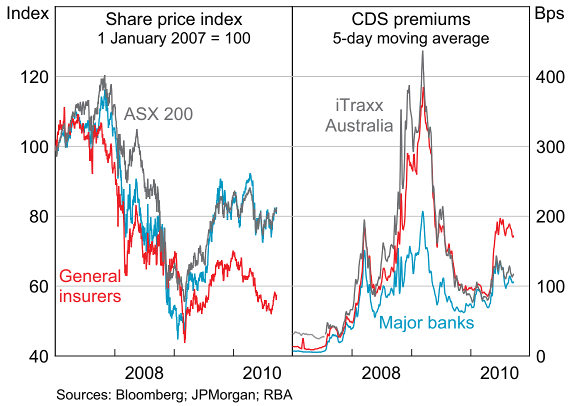
The general insurance industry remains soundly capitalised, holding around double the regulatory minimum as at March 2010 (the latest available data). APRA is in the process of reviewing the capital standards of insurers, with an aim of making the capital framework more risk sensitive. The new proposed framework encompasses a three-pillar system, similar to what is already in place for banks, which will improve the dissemination of data to the market. Prescribed capital requirements for general insurers will also be revised and there will be increased scope for supervisory adjustments to account for any insurer-specific risks. APRA has already begun liaising with the industry, and has a schedule to implement the revised standards in 2012.

The credit ratings of the four largest general insurers' Australian operations remain high, with all rated A+ or higher by Standard and Poor's. However, share prices of the largest listed Australian insurers have fallen by around 20 per cent from the recent peak in January 2010 (Graph 52). This appears to be mainly due to investors factoring in the effects of increased claims, less favourable trading updates by some large insurers in mid 2010, and some caution about future growth prospects. In line with the movements in share prices, the insurers' CDS premia have increased slightly in recent months.

A significant share of Australian insurers' reinsurance cover is provided by several large global reinsurers, who have reported a rise in profits in the past year despite a large number of catastrophe events. Their credit ratings remain high and analysts generally expect them to remain profitable.

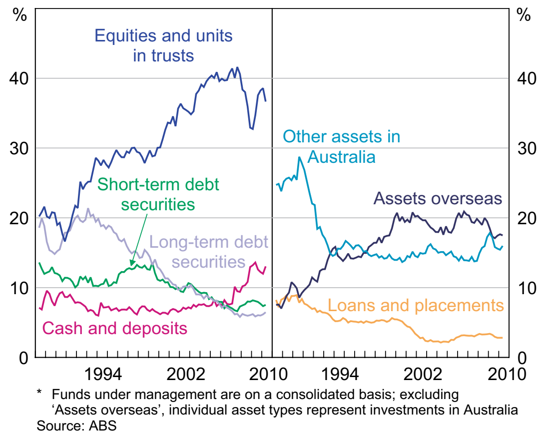
Operating conditions for the two largest providers of lenders' mortgage insurance (LMI) in Australia – QBE and Genworth – appear to have improved. Both reported a decline in claim ratios over the past year, with part of this likely due to prior efforts by these insurers to improve their underwriting standards. As a result, the Australian mortgage insurance operations of QBE and Genworth continue to be rated highly, with credit ratings of AA- from Standard and Poor's accompanied by stable outlooks.

Graph 52
Financial Market Indicators



Sources: Bloomberg; JPMorgan; RBA

Graph 53
Allocation of Domestic Funds Under Management*



* Funds under management are on a consolidated basis; excluding 'Assets overseas', individual asset types represent investments in Australia
Source: ABS

Managed Funds

Growth in assets held by domestic funds management institutions slowed in the latest half-year. Total assets remained little changed over the six months to June 2010, compared to growth of 23 per cent over the December 2009 half-year (Table 6). Assets at superannuation funds, which account for around 65 per cent of total assets under management, increased over the latest half-year, while total assets fell at all the other fund managers. Holdings of equities and units in trusts fell considerably over the June 2010 half-year, in part due to the volatility in markets earlier in 2010 (Graph 53). This fall was offset by increases in cash and deposits, long-term securities and other assets in Australia.

Table 6: Assets of Domestic Funds Management Institutions[(a)]
June 2010

	Level	Share of total	Six-month-ended annualised change	
			Dec 09	Jun 10
	$billion	Per cent	Per cent	Per cent
Superannuation funds (consolidated)	**872**	**65**	**31.5**	**3.4**
Superannuation funds (unconsolidated)	1035		30.9	2.4
of which:				
Equities	*315*	*30*	*55.4*	*–9.5*
Assets overseas	*173*	*17*	*32.7*	*2.9*
Cash and deposits	*171*	*17*	*1.6*	*11.4*
Units in trusts	*144*	*14*	*32.7*	*1.0*
Other assets in Australia[(b)]	*106*	*10*	*8.1*	*19.3*
Short-term securities	*58*	*6*	*46.7*	*4.4*
Long-term securities	*57*	*5*	*26.7*	*22.7*
Loans and placements	*10*	*1*	*29.4*	*12.0*
Life insurers[(c)] (consolidated)	**177**	**13**	**24.8**	**–4.9**
Public unit trusts (consolidated)	**256**	**19**	**8.3**	**–2.6**
Public unit trusts (unconsolidated)	295		15.0	–0.8
of which:				
Listed property trusts	*123*	*41*	*–0.4*	*–0.2*
Unlisted equity trusts	*100*	*34*	*70.5*	*2.0*
Listed equity trusts	*45*	*15*	*–10.9*	*–6.0*
Other trusts	*28*	*9*	*–1.8*	*–4.2*
Other managed funds[(d)] (consolidated)	**46**	**3**	**–23.0**	**–8.9**
Total (consolidated)	**1 351**	**100**	**22.9**	**0.7**
of which:				
All superannuation assets[(e)]	1 030		30.8	2.0

(a) Excluding funds sourced from overseas, government, other trusts, general insurance and 'other' sources
(b) Includes non-financial assets
(c) Includes superannuation funds held in the statutory funds of life insurers
(d) Cash management trusts, common funds and friendly societies
(e) Superannuation funds plus an estimate of the superannuation assets held in the statutory funds of life insurers
Sources: ABS; RBA

Several regulatory reviews were released in the past year that may have implications for the managed funds sector. The Inquiry into Financial Products and Services in Australia addressed strengthening the framework of the funds management industry as a whole. Recommendations from the Super System Review and the Report on Australia's Future Tax System were more specific to the superannuation industry. Details of any changes to flow from these reports, however, are yet to be determined.

Superannuation Funds

Superannuation funds' consolidated assets under management rose at an annualised rate of 3½ per cent over the six months to June 2010, down from around 30 per cent for the December 2009 half-year. The subdued growth in the latest half-year was due to a 10 per cent fall in equity holdings, which make up the largest share of unconsolidated superannuation assets. This fall was

in part due to the decline in the value of equity holdings in early 2010. More than offsetting the fall were the increases in all other asset categories, with long-term securities and other assets experiencing the strongest growth.

Superannuation funds recorded a $70 billion gain on their investment portfolios over the year to June 2010, which was in line with pre-crisis experiences (Graph 54). This compared to losses of $95 billion in the previous year. Investment income, however, was affected by the market disruption in the June quarter 2010 as losses resulted from the fall in equity prices. Inflows to superannuation funds over the year were broadly steady at rates similar to those of recent years.

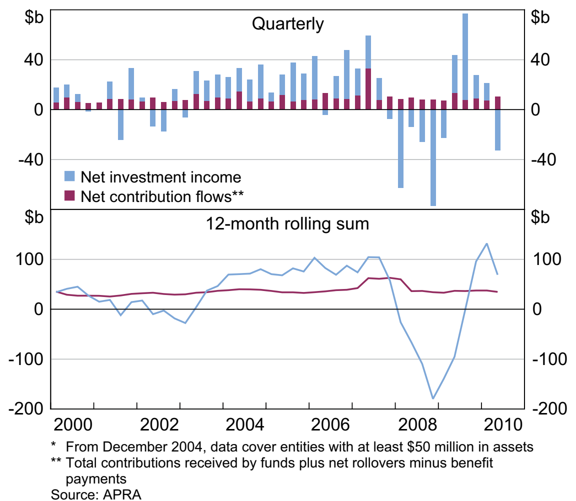
Life Insurers

Life insurers' consolidated assets fell at an annualised rate of 5 per cent over the six months to June 2010, compared to an increase of around 25 per cent in the December 2009 half-year. Life insurers' superannuation businesses continue to account for around 90 per cent of total assets.

Life insurers recorded an aggregate loss from investments of $2½ billion in the six months to June 2010, compared to a gain of $25 billion in the December 2009 half-year (Graph 55). These results were in line with the general trajectory of markets. Despite the large fall in investment income, the fall in profits was relatively small as policyholders bore most of the losses. Post-tax profits were $1.4 billion for the half-year to June 2010, down from $1.9 billion in the December 2009 half-year. The contribution to profits from net premium income and net policy payments remained fairly stable over the year to June 2010.

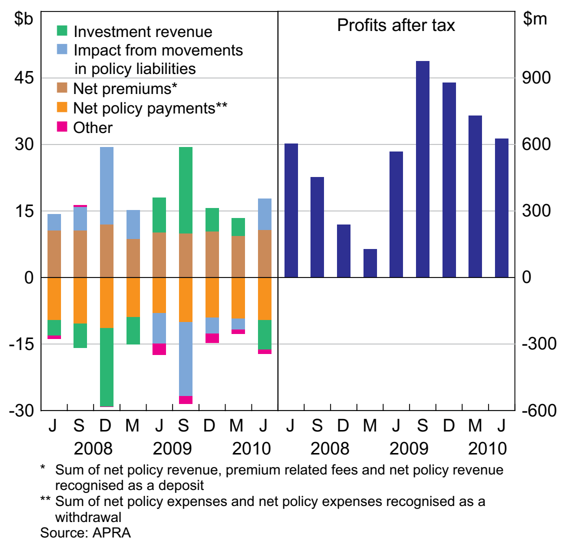
Life insurers' capital position remained broadly stable over the year, with the industry holding 1.5 times the regulatory minimum as at June 2010; as for general insurers, though, APRA is in the process of revising the capital standards for life insurers. One of the main proposals is to replace the current solvency and capital requirements with a new single measure of capital.

Graph 54
Superannuation Funds' Financial Performance*



* From December 2004, data cover entities with at least $50 million in assets
** Total contributions received by funds plus net rollovers minus benefit payments
Source: APRA

Graph 55
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

Public Unit Trusts and Other Managed Funds

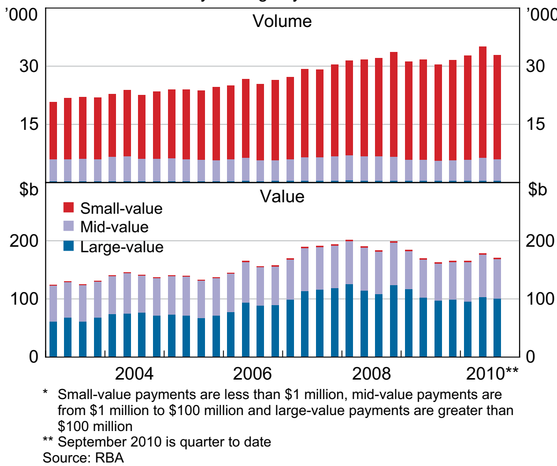
Outside of superannuation funds and life offices, the bulk of assets under management are invested in public unit trusts. On a consolidated basis, public unit trusts' assets fell at an annualised rate of around 2½ per cent over the six months to June 2010, compared to an increase of 8 per cent in the December 2009 half-year. The fall in the latest

half-year was largely attributable to the assets of listed equity trusts, which fell at an annualised rate of 6 per cent, to be around 20 per cent below its late 2007 peak at June 2010. The assets of unlisted equity trusts and listed property trusts remained broadly stable in the recent half-year.

Market Infrastructure

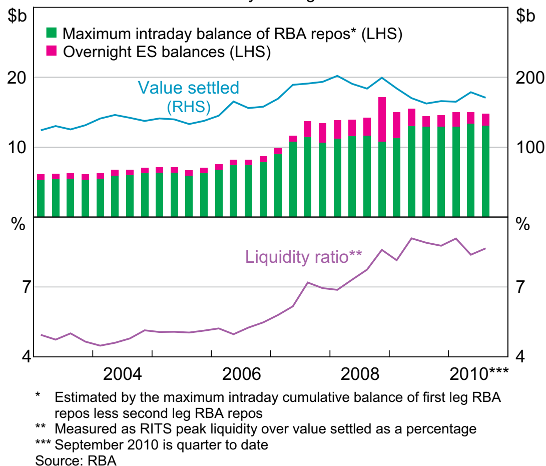
Australia's payment system infrastructure continues to perform smoothly. The volume of transactions processed by the infrastructure has now largely returned to normal after having declined during the crisis period. Some of the changes to participant behaviour and system risk controls that resulted from the heightened risks during the crisis have been unwound. Risks faced by the central counterparties increased somewhat towards the middle of 2010, however, due to higher volatility resulting from concerns regarding European public debt and the 'flash crash' in the US equity market, discussed in the chapter on 'The Global Financial Environment'. Nevertheless, these risks remain well below those experienced in late 2008 and early 2009.

Graph 56
RITS Settled Payments
Daily average by value-band*



* Small-value payments are less than $1 million, mid-value payments are from $1 million to $100 million and large-value payments are greater than $100 million
** September 2010 is quarter to date
Source: RBA

Graph 57
RITS Peak Liquidity
Daily average



* Estimated by the maximum intraday cumulative balance of first leg RBA repos less second leg RBA repos
** Measured as RITS peak liquidity over value settled as a percentage
*** September 2010 is quarter to date
Source: RBA

In Australia, high-value transactions settle on a real-time gross settlement (RTGS) basis through the Reserve Bank Information and Transfer System (RITS). Settlement activity in RITS has picked up in recent quarters (Graph 56). Daily average transaction volumes have now recovered to their pre-crisis levels, reaching a new peak in June 2010. Although average daily values grew strongly in the second quarter of 2010, they currently remain more than 14 per cent below the previous peak in the final quarter of 2008. This is due to lower settlement activity in the relatively small number of large-value payments (over $100 million).

Settlement of RTGS transactions occurs across Exchange Settlement (ES) accounts held at the Reserve Bank. RITS daily peak liquidity – as measured by the sum of overnight ES balances and maximum intraday repurchase agreements with the Reserve Bank – increased in late 2008, following the collapse of Lehman Brothers (Graph 57). While this increase in liquidity coincided with a peak in RITS transaction values, it also reflected that RITS participants were demanding more liquidity in the face of the market uncertainty. System liquidity has since declined, and has remained steady over recent quarters. However, even after accounting for the increase in settlement activity during the June quarter 2010, liquidity remains high relative to historical averages on this measure.

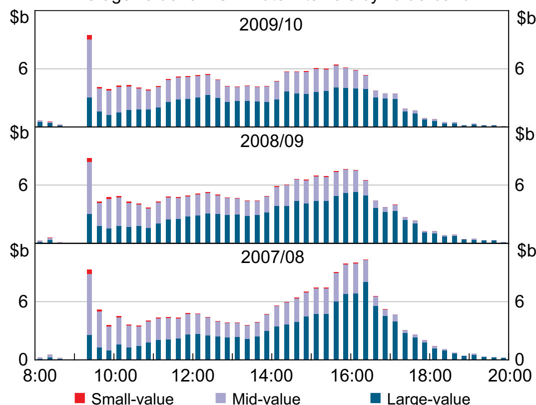
Ample system liquidity has allowed payments to continue to settle in a timely, orderly way. Indeed, the value of payments being settled has become more evenly distributed throughout the day over

recent years. In particular, the value of payments being settled late in the day has fallen noticeably (Graph 58).

Clearing of transactions in equity and derivative markets in Australia is conducted by two central counterparties, ASX Clear and ASX Clear (Futures).[6] By novation of transactions to the central counterparties – i.e. replacement of the initial contracts between counterparties with two new contracts between the central counterparty and each of the initial counterparties – the risk arising from counterparty default is transferred to the central counterparty. As a result, the robustness of central counterparties' risk controls is a key focus of their regulators. In Australia, the Reserve Bank is the regulator for stability purposes. Both Australian central counterparties appropriately adjusted their risk controls during the crisis period and subsequent recovery, and have functioned smoothly throughout.

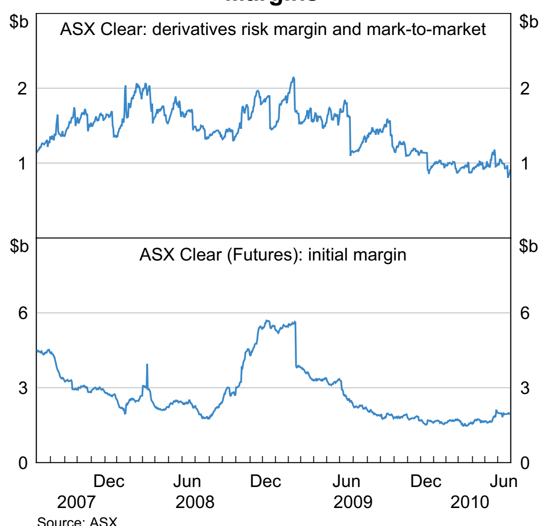
As financial markets and risk appetite recovered, the volume of equities and derivatives transactions processed by the central counterparties increased strongly in 2009/10. Even though trading activity increased, both ASX Clear and ASX Clear (Futures) generally reduced initial margin rates for derivatives over 2009/10, reflecting the decline in risk as market volatility declined (Graph 59). However, following the concerns arising out of the ongoing financial fragilities in some European countries and the 'flash crash', central counterparties adjusted some of their risk controls by increasing stress-test parameters, raising margin rates, and removing discounting of additional cover required on large potential exposures identified through stress testing. Combined with the increase in activity, these adjustments resulted in a moderate increase in average initial margin held at ASX Clear (Futures) over the second quarter of 2010, although margin held at ASX Clear remained steady. The number of intraday margin calls also increased at both central counterparties.

Graph 58
RITS Intraday Settlement Profile
Average value for 15 minute intervals by value-band*



* Small-value payments are less than $1 million, mid-value payments are from $1 million to $100 million and large-value payments are greater than $100 million
Source: RBA

Graph 59
Margins



Source: ASX

6 Prior to 1 August 2010, the two central counterparties were known as Australian Clearing House (ACH) and SFE Clearing Corporation (SFECC).