3. Resilience of the Australian Financial System

Summary

The global and domestic macroeconomic environment is challenging. Global financial stability risks are elevated and could spill over to Australia through a range of channels. The tightening of monetary policy in response to high inflation internationally and in Australia has put pressure on the incomes and balance sheets of many households and businesses, making them vulnerable to further shocks. Inflation and interest rates remaining high for longer than expected or a sharp economic downturn, possibly transmitted from abroad, could lead to a substantial tightening in financial conditions internationally and in Australia.

However, the Australian financial system is navigating these challenges from a strong position and its overall resilience remains high.

- **Banks remain well positioned to deal with these risks.** Australian banks are profitable and hold capital and liquid assets in excess of regulatory requirements. Banks' funding sources are relatively stable and include a large share of domestic deposits, leaving them well placed if there were to be disruptions to international funding market conditions. Higher interest rates affect the balance sheets and cash flows of Australian banks in a range of ways, but the direct impacts are being prudently managed (see 5.4 Focus Topic: Interest Rate Risk).
- **Many non-bank lenders are experiencing a challenging environment for funding and/or asset quality, but systemic risks to the overall financial system posed by non-bank lenders remain low in Australia.** Funding costs and arrears have increased for non-bank lenders, and they are facing strong competition from banks for high-quality borrowers. As a result, growth in housing and some segments of business lending by non-banks has slowed materially and their margins have declined, leading some to lend to higher risk segments or to loosen lending standards to maintain lending volumes and margins. While this may lead to lower credit quality, the share of overall housing and business credit from non-banks remains small.
- **Higher insurance premiums could lead to a shift in risk to some households and businesses that may not be well suited to bear that risk.** Inflation and reinsurance

costs have led insurers to materially increase premiums. Some policyholders have responded by increasing excess payments and reducing insurance coverage. Uninsured assets may be challenging to finance or refinance.

- **Operational resilience, strong governance and confidence are important elements of the overall resilience of the financial system.** Australian financial institutions, including financial market infrastructures (FMIs) such as central counterparties, have bolstered their operational resilience in recent years under the supervision of the Australian Prudential Regulation Authority (APRA) and the Reserve Bank. Cyber risks remain elevated, and while financial institutions and FMIs have increased their resilience to cyber events over recent years, the threat environment dictates that remaining gaps be addressed as a priority (see 5.5 Focus Topic: Operational Risk in a Digital World).

3.1 Banks

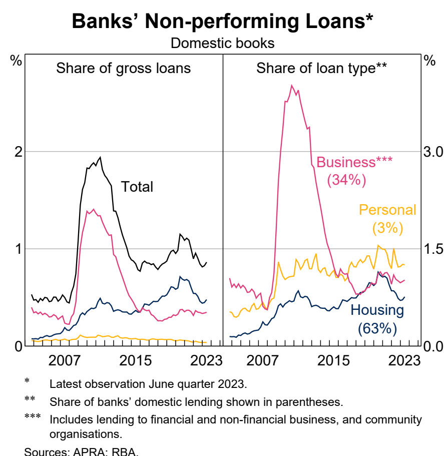
Tighter financial conditions and weaker economic activity pose some risk to banks' credit quality …

Timely information points to a slight deterioration in banks' credit quality as higher interest rates, increases in the cost of living and weaker economic activity have made it more difficult for borrowers to service their debts. Credit risk is the largest component of risk banks hold capital against, so developments in the credit quality of the banking system warrant close scrutiny. Banks' non-performing loans (NPLs) have increased slightly in recent quarters but remain near decade lows as the strong labour market, reductions in discretionary spending and high savings buffers accumulated during the COVID-19 pandemic have allowed most borrowers to adjust to higher repayments.[1]

By lending category, owner-occupier housing loans have accounted for most of the increase in NPLs. NPLs for investor housing, non-financial businesses and personal loans have been broadly stable in recent quarters (Graph 3.1). Residential mortgage lending makes up the largest share of banks' risk-weighted credit exposures, at 40 per cent, though this is lower than the actual share of mortgage lending, as it is considered less risky than lending to other sectors such as corporate or SME borrowers (Graph 3.2).

Despite challenging conditions in the Australian commercial real estate (CRE) sector, bank NPLs from domestic CRE exposure remain very low (see Graph 2.24 in Chapter 2: Resilience of Australian Households and Businesses). Australian banks have established conservative lending practices in CRE markets and have further reduced their exposures to CRE as a proportion of their lending since the global financial crisis (GFC) (which in turn were lower than in the early-1990s downturn). As a result, risks to the Australian banking system from CRE lending appear low.[2]

Graph 3.1



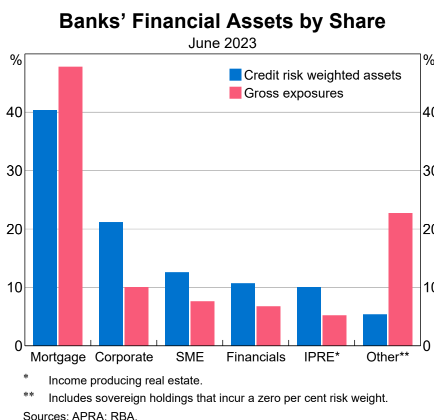
* Latest observation June quarter 2023.

** Share of banks' domestic lending shown in parentheses.

*** Includes lending to financial and non-financial business, and community organisations.

Sources: APRA; RBA.

Graph 3.2



* Income producing real estate.

** Includes sovereign holdings that incur a zero per cent risk weight.

Sources: APRA; RBA.

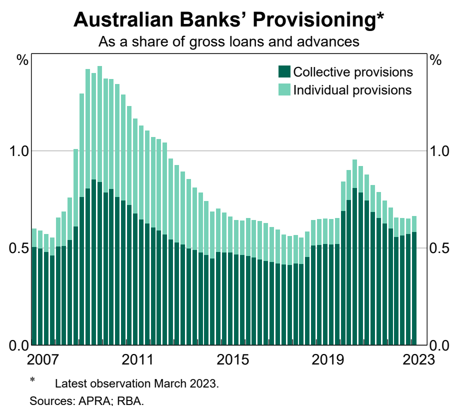
Financial pressures, for both businesses and households, are expected to persist for some time as the impact of higher interest rates continues to work through the economy. Leading indicators for bank credit quality, such as early-stage housing arrears, are consistent with some further increase in NPLs over the coming year (see Chapter 2: Resilience of Australian Households and Businesses).[3]

A large negative shock to employment is a significant upside risk to banks' NPLs. Historically, increases in unemployment have been associated with rising NPLs in Australia and other advanced economies. Household and business finances would face additional pressure if inflation and interest rates remain high for longer than anticipated. However, sound lending standards under APRA's regulatory framework decrease the risk of losses to banks by reducing the probability that a borrower will be unable to meet their loan repayments – even if incomes were temporarily reduced – and by helping to ensure that collateral would be sufficient to meet any shortfall in outstanding obligations. Most mortgage holders have experienced an increase in the value of their property since loan origination, adding to the initial equity in their home. Absent large falls in property values, this limits losses for banks in the event of default (see Graph 2.13 in Chapter 2: Resilience of Australian Households and Businesses).

… but profits and high levels of capital leave them well placed to manage this risk.

Banks are well placed to manage a rise in loan defaults. Banks raise provisions – earnings set aside against future credit losses – in response to changes in credit risk relating to specific borrowers (individual provisions) and to portfolios of loans with similar risk characteristics (collective provisions). Collective provisions are determined by banks' models of expected credit loss (ECL), supplemented by an additional overlay and forward-looking adjustments based on judgement of risks. Australian banks' level of provisioning is currently at levels similar to those prior to the pandemic (Graph 3.3). Despite the risks to the economic outlook, this is a result of ECLs on mortgages running at low levels (below the average of the past five years), which partly reflects that the vast majority of mortgage holders remain in positive equity.

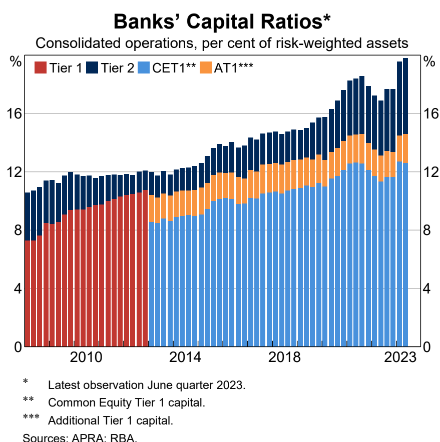
Graph 3.3



Banks' profits leave them well placed to increase provisions and absorb greater loan losses if economic conditions worsen more than expected. In recent years, lending volume growth and lower impairment charges have supported profitability. Higher interest rates have supported net interest margins (NIMs) through higher earnings on interest rate hedges and holdings of high-quality liquid assets (HQLA). More recently, slowing loan growth and competition for mortgage lending and deposits have weighed on profits, and banks expect these trends to continue.[4]

Australian banks hold capital well above regulatory requirements, bolstering their resilience to unexpected losses. Over the past decade, total capital has increased by around 6 per cent of banks' risk-weighted assets, reflecting tighter prudential standards and buffers that banks maintain above regulatory requirements (Graph 3.4). Total capital as a share of banks' risk-weighted assets increased to 19.8 per cent in the June quarter; the major banks' capital ratios remain well above the loss absorbing capacity requirement of 18.25 per cent, due to come into effect in 2026 for domestic systemically important banks. Banks' Common Equity Tier 1 (CET1) capital – the highest quality of regulatory capital – was 12.6 per cent of banks' risk-weighted assets in the June quarter, and well above levels prevailing before the pandemic.[5] Capital levels are sufficiently high that some banks have recently completed share buy-backs or announced their intention to do so, to bring capital ratios more in line with internal targets.

Graph 3.4



Banks have remained resilient to funding and liquidity stresses …

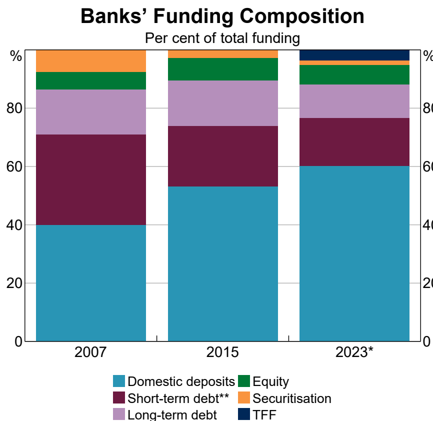
Since the GFC, Australian banks have transitioned to a more resilient funding model (Graph 3.5). Around 60 per cent of banks' funding is from domestic deposits, three-quarters of which is comprised of more stable types of deposits that are less susceptible to flight risk. The largest share of deposits is from households, which are considered the most stable source of funding. The next largest source of deposits is from non-financial corporates, most of which are for operational purposes (such as facilitating payroll) and are also considered relatively stable.

Also since the GFC, banks have de-risked their debt funding profile. They have done so by extending the maturity of wholesale debt – the weighted average residual maturity has increased from three to four years since 2008 – and by reducing their reliance on short-term debt funding. Longer and more staggered

maturities reduce banks' refinancing risks, as a smaller proportion of debt needs to be replaced each year. This makes banks more resilient to periodic disruptions to funding markets. Large and complex banks also continue to comfortably meet their Net Stable Funding Ratio requirement, which is designed to ensure they have robust long-term funding profiles.

Graph 3.5

Banks' Funding Composition



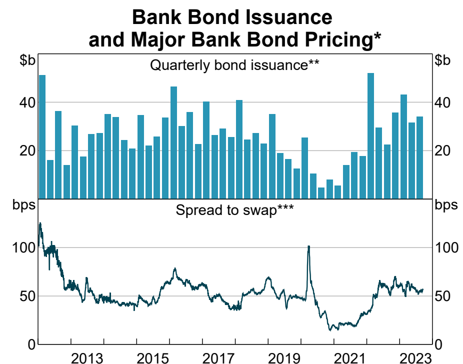
* June end, all other dates are December end.
** Includes deposits and intragroup funding from non-residents.
Sources: ABS; APRA; Bloomberg; RBA; Refinitiv.

Banks have adapted their funding plans to maintain access to markets through changing financial conditions. In the past two years, banks have encountered volatility in funding markets associated with Russia's invasion of Ukraine in 2022 and banking stresses in some overseas jurisdictions in early 2023. Over this period, Australian banks' debt issuance has been high (relative to history) as banks funded strong balance sheet growth, replaced the Committed Liquidity Facility (which was phased out at the end of 2022), and prepared to repay funds borrowed under the Reserve Bank's Term Funding Facility (TFF). Covered bond issuance was particularly strong and, at times, banks shortened the tenor of their issuance, reflecting increased investor preference for lower risk instruments amid uncertain economic and financial market conditions. Banks issued a greater-than-usual share of domestic bonds over this period as Australian funding markets were less affected by international events. Despite large amounts of issuance and periods of financial market volatility, the spread of major bank bond yields to the three-year swap rate – a key pricing benchmark for bank bond issuance – has remained around its decade average (Graph 3.6). This suggests that markets have absorbed the issuance well and that banks have maintained their strong reputation among investors.

Banks hold significant buffers of liquid assets above regulatory requirements, enhancing their resilience to adverse liquidity conditions. Large and complex banks subject to the Liquidity Coverage Ratio requirement continue to maintain significant holdings of HQLA, even as repayments of the TFF reduce their Exchange Settlement (ES) balances at the Reserve Bank (see below). Smaller and less complex banks also comfortably meet their Minimum Liquidity Holding ratio requirements, which aim to ensure they maintain a sufficient portfolio of liquid assets that can be quickly converted to cash if required.

Graph 3.6

Bank Bond Issuance and Major Bank Bond Pricing*



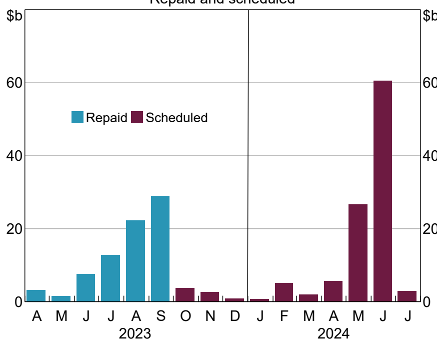
* Latest observation 19 September 2023.
** Senior unsecured and covered bond issuance.
*** Domestic secondary market; 3-year target tenor.
Sources: Bloomberg; RBA.

… and their large funding task is progressing smoothly.

Banks have begun repaying funds borrowed under the TFF. Of the $188 billion borrowed, $77 billion had been repaid by the end of September 2023, including $64 billion in the September quarter. This represents the first of two concentrated maturity periods, with $93 billion to mature in the June quarter of 2024 (Graph 3.7). The remaining TFF repayments are unlikely to pose a significant challenge for the banking sector overall, provided banks continue to manage their funding needs proactively.

The repayment of the TFF has implications for banks' liquidity management. When banks borrowed under the TFF, they primarily pledged self-securitised assets as collateral that do not qualify as liquid assets. In return, they received highly liquid ES balances that added to their liquid assets. As banks repay the TFF, the reverse applies; ES balances decline and banks' liquid assets holdings decrease. To maintain their liquidity ratios, banks need to source additional liquid assets (or reduce their net cash outflows).[6] As a result, there has been strong demand from banks for both Australian Government Securities and securities issued by the central borrowing authorities of the states and territories, both of which qualify as liquid assets.

Graph 3.7



* Latest observation September end 2023.
Source: RBA.

Overall, the risks to Australia's financial system from the banking sector remain low.

While financial stress for households and businesses could impact banks' credit quality, it will have limited impact on their overall resilience due to the following:

- *Banks are well positioned for a turn in the credit cycle*. They are well capitalised, profitable and have raised provisions, putting them in a strong position to weather an increase in loan arrears.
- *Banks' funding model consists of a high proportion of stable deposits, and they continue to hold high levels of liquid assets*, which should allow banks to continue to support economic activity even during more challenging funding market conditions.

3.2 Non-bank lenders

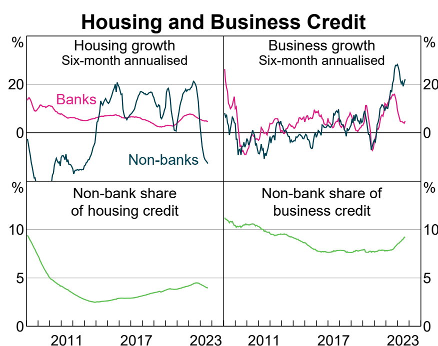
Non-bank loan quality may come under pressure.

Until recently, non-bank credit to both households and businesses had been accelerating at a fast pace, as low funding costs and fast turnaround times enabled non-banks to compete with banks for prime borrowers. Despite rapid growth in credit, there was no evidence that non-bank underwriting standards had materially weakened.[7]

Non-bank housing credit growth has slowed over 2023 as interest rates have increased and non-bank funding costs have risen by more than for banks (which benefit from low-rate deposit funding). Non-banks typically fund their mortgage lending through residential mortgage-backed securities (RBMS). While strong demand for highly rated investments has supported pricing of investment-grade RMBS, weaker demand for non-investment-grade RMBS has led to a significant increase in funding costs for non-bank lenders. Non-banks have either had to pay these higher funding costs or

put more of their own equity into RMBS deals. Competitive pricing and cashback offers from banks have eroded non-banks' margins and share of new lending (Graph 3.8). Reductions in borrowers' servicing capacity has also dampened demand for credit.

The outlook for non-banks' housing loan quality is more challenging than in recent years. In an effort to rebuild margins and lending volumes, liaison discussions indicate that some non-bank lenders are relaxing serviceability requirements and targeting higher risk borrower segments, such as those with less documentation about their finances. At the same time, some non-banks have found it difficult to retain credit-worthy borrowers who have sought to refinance their loans on highly competitive terms with banks. A weakening in lending standards and overall loan quality could lead to more risk concentrating in a part of the financial system where regulators have less oversight. Housing loan arrears for non-banks have risen by more than for banks (to levels recorded just before the pandemic), partly because they lend to borrowers who are more sensitive to economic conditions, such as the self-employed. Non-bank lenders also have a higher share of variable-rate lending so interest rate rises, and associated debt-servicing difficulties, pass through more quickly to their loan book.



There are important mitigants to the financial stability risks posed by non-banks' housing lending. Market discipline acts as a key mechanism that helps to limit how far non-bank lenders can ease lending standards and how far along the risk spectrum they can operate. Loan warehouse limits for securitisations act as a constraint in this regard, while RMBS reporting requirements provide investors with visibility into underlying loan quality. And unlike in some other advanced economies, non-banks account for a small share of overall housing credit in Australia (less than 5 per cent) and have limited connections to the banking sector.

Non-bank business credit growth has eased slightly but remains elevated both historically and relative to banks (Graph 3.8). To support margins, non-banks have increased some higher risk forms of business lending, including property development, construction, auto loans and lending to self-managed super funds. Non-bank business lending is predominantly financed through external debt or equity. As these loans are not securitised, they are not subject to warehousing limits on lending standards and loan quality is less transparent, making it more difficult to monitor the build-up of risks. While non-banks' share of business lending has increased, at around 9 per cent it comprises only a small share of total business lending in Australia.

Overall, the risks to Australia's broader financial system from non-bank lenders remain low.

Some non-banks' loosening of lending standards and transition towards riskier lending segments warrants careful monitoring in the period ahead. However, the sector is unlikely to pose systemic risks while non-bank lending remains a relatively small part of Australia's financial system (around 7 per cent of total credit) and interconnectedness with the

traditional banking sector is not a principal feature of their operations.

3.3 Insurers

Lower insurance coverage could result in a redistribution of risk.

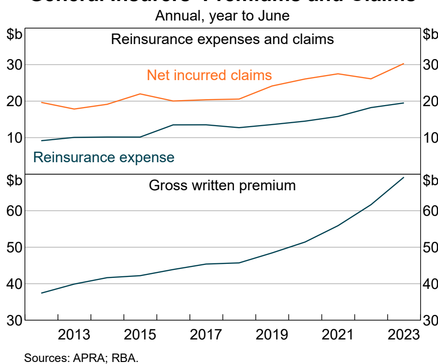
Higher inflation and a series of severe natural disasters, including recent flood events on Australia's east coast, have increased the cost of claims and weighed on profits for general insurers. Net incurred claims increased by more than 16 per cent to $30.3 billion in the year to June 2023, and by nearly 50 per cent over the past five years (Graph 3.9). The greater frequency and severity of natural disasters, such as floods and storms, have also been reflected in higher reinsurance expenses, which increased by over 50 per cent between June 2018 and June 2023.

In response, there have been reports that Australian insurers are having to adopt larger retentions – the amount of a claim they must cover before reinsurance applies – transferring extra risk to retail insurers and requiring them to hold additional capital. Higher reinsurance and claims costs are being passed on to policyholders through higher premiums, with gross written premiums for general insurers increasing over 12 per cent in the year ending June 2023 (Graph 3.9).

Graph 3.9

General Insurers' Premiums and Claims

Annual, year to June



Taken together, these shifts in the Australian insurance landscape are leading to a redistribution of risk. Retail insurers are absorbing more risk to manage the challenging reinsurance market. Higher premiums are placing pressure on insurance affordability for households and businesses, which is likely to result in policyholders taking on more risk through higher excess payments and reductions in insurance coverage. APRA recently reported that some small- to medium-sized businesses have been increasing deductibles since premiums started to rise in 2017.[8] If insurance coverage declines, future risk events would lead to larger downstream impacts on household and business finances, and thereby consumption and business activity.

This risk redistribution will impact regions unevenly, as highlighted in recent analysis by the Actuaries Institute.[9] Premium increases are most severe in areas heavily exposed to natural disasters, typically non-metropolitan localities. Given that lower socio-economic groups often live in these riskier locations, the impact of reduced insurance access, both through price and availability, will heavily affect certain communities.

Lower insurance coverage would have an impact on banks and their willingness to lend to regions more prone to natural disasters. Lower insurance coverage on assets that banks take as collateral, such as property, would mean they face greater potential losses on their lending in areas more affected by natural disasters. Banks are likely to respond by reducing their lending to these regions if insurance coverage is not obtained by borrowers.

Several initiatives aim to better understand and address these and other challenges facing Australia's insurance sector.

These include the following:

- APRA, on behalf of the Council of Financial Regulators, will conduct a climate scenario

analysis with insurers to analyse the impact of climate change on the affordability of household insurance out to 2050.

- The Australian Government's parliamentary inquiry into the insurance industry's response to the 2022 floods will investigate insurance affordability, land-use planning and mitigation options.
- The Cyclone Reinsurance Pool, backed by a $10 billion government guarantee, aims to reduce premiums for cyclone and related flood damage. This will ensure that the premiums are charged without the need to cover the cost of capital, profit margin and other overheads that would normally be charged.
- The National Emergency Management Agency administers the Disaster Ready Fund, which provides funding for natural disaster resilience and risk reduction, and the Hazard Insurance Partnership, which is investigating policy solutions to reduce risk and insurance costs.

APRA has also highlighted the availability of catastrophe bonds and other insurance-linked securities (ILS), which are not commonly used in Australia, to manage risk amid a challenging reinsurance market.[10] ILS can be used to bolster the pool of capital available to absorb losses from natural catastrophes and other disruptions or provide a mechanism to transfer risk to other parties.

Endnotes

[1] A loan is considered non-performing if a borrower is 90 days or more past-due on a credit obligation or the lender considers that the borrower is unlikely to pay in full.

[2] See Lim J, M McCormick, S Roche and E Smith (2023), 'Financial Stability Risks from Commercial Real Estate', RBA *Bulletin*, September.

[3] Early-stage arrears refers to loans that are overdue by fewer than 90 days.

[4] This is consistent with research from the Bank for International Settlements finding that bank profits tend to increase at the start of an interest rate tightening cycle and decrease as loan growth slows and customers move to higher interest rate deposits. See Bank for International Settlements (2023), 'Box B: Rising Policy Rates and the Outlook for Banks' Net Interest Margins', *Annual Economic Report*, June.

[5] Banks' CET1 ratios increased following the implementation of APRA's 'unquestionably strong' framework in January 2023, reflecting lower average risk-weights. For more information about the effect of the new capital framework on Australian banks' capital positions, see RBA (2023), 'The Australian Financial System', *Financial Stability Review*, April.

[6] See Jacobs D (2023), 'Australian Fixed Income Markets – Recent Developments and a Look Ahead', Speech at the Australian Government Fixed Income Forum, Tokyo, 24 May.

[7] Non-bank lenders provide credit to parts of the economy that are underserved by banks and play an important role in the financial system. However, sustained strong growth in non-bank credit can lead to a build-up of risk in a more lightly regulated part of the financial system, particularly if lending standards are not maintained. See Hudson C, S Kurian and M Lewis (2023), 'Non-bank Lending in Australia and the Implications for Financial Stability', RBA *Bulletin*, March.

[8] APRA (2023), 'NCPD Analysis: Review of Claims Trends and Affordability of Public Liability and Professional Indemnity Insurance in Australia'.

[9] Actuaries Institute (2023), 'Home Insurance Affordability Update', August.

[10] APRA (2023), 'APRA's Reinsurance Requirements and the Use of Insurance Linked Securities', August.