

The Australian Financial System

The Australian financial system has remained resilient in the face of the financial and economic turmoil that has affected many developed countries over recent years. Income streams for banks have remained comparatively stable, losses from securities and loans have been relatively mild and, as a whole, the banking system has continued to be very profitable. Initial indicators suggest that the gradual rise in bad debts is likely to have peaked, and this has strengthened the outlook for profits. The availability of funding has also improved, allowing banks to reduce their use of the Australian Government wholesale funding guarantee. Lending to businesses has contracted over the past six months as businesses have tended to access non-intermediated sources of funds and to deleverage, but banks have continued to expand lending for housing.

Profits and Asset Quality of the Banking System

The four major banks reported headline profits after tax and minority interests totalling around \$6 billion in their latest available half yearly results (Table 3). This result was about \$2 billion lower than in the same period last year, though the fall almost entirely reflects a one-off tax revaluation that affected New Zealand operations. The smaller banks have generally also remained profitable, despite being more severely affected by the downturn. The regional banks, in aggregate, reported \$0.2 billion in profit for the latest half year, slightly higher than for the same period in the previous year, as they benefited from a fall in bad and doubtful debt expenses. Foreign-owned banks have recovered some earlier losses made when the

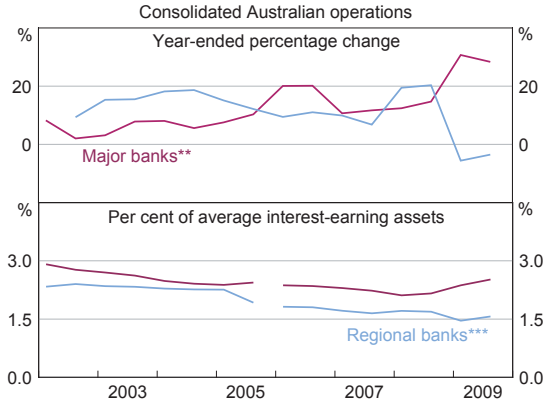
Table 3: Major Banks' Latest Half Year Profit Results^(a)
Consolidated global operations

	2008 \$billion	2009 \$billion	Change \$billion
Income			
Net interest income	20.0	23.4	3.4
Non-interest income	9.2	9.6	0.4
Expenses			
Operating expenses	14.3	15.4	1.1
Bad and doubtful debts	5.7	6.7	1.0
Profit			
Net profit before tax	9.2	10.9	1.7
Net profit after tax and minority interests	7.5	5.6	-1.8

(a) Half year to September for ANZ Banking Group, National Australia Bank and Westpac Banking Corporation; half year to December for Commonwealth Bank of Australia. Includes St George Bank and Bankwest.
Sources: RBA; banks' annual and interim reports

Graph 25

Australian-owned Banks' Net Interest Income*

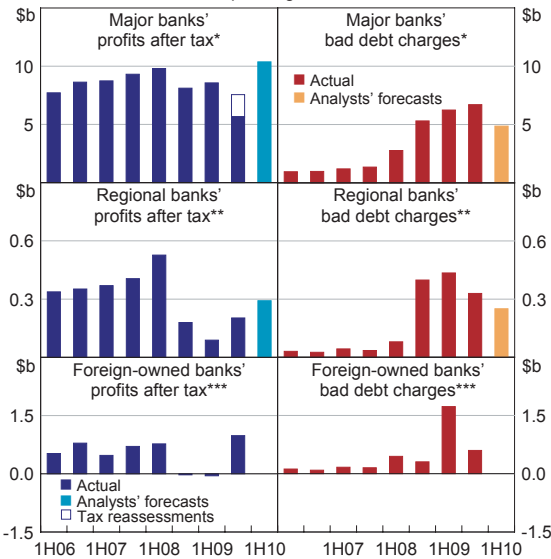


* From 2006 data are on an IFRS basis; prior years are on an AGAAP basis.
 ** Second half figures are annualised half year to December for CBA and half year to September for ANZ, NAB and Westpac. Includes St George, and Bankwest from the first half of 2009.
 *** Second half figures are annualised half year to December for Suncorp-Metway and Bendigo and Adelaide Bank, and half year to August for Bank of Queensland.
 Sources: RBA; banks' annual and interim reports

Graph 26

Profitability

Banks operating in Australia



* Second half figures are half year to December for CBA and half year to September for ANZ, NAB and Westpac. Includes St George, and Bankwest from the first half of 2009.
 ** Second half figures are half year to December for Suncorp-Metway and Bendigo and Adelaide Bank, and half year to August for Bank of Queensland.
 *** Second half figures are half year to September. Includes Bankwest up to the second half of 2008.
 Sources: APRA; Citigroup; Morgan Stanley; UBS; banks' annual and interim reports

impact of the financial turmoil peaked and bad debt charges spiked sharply. Profits have picked up more recently as their bad debt charges in the half year to September 2009 receded.

Net interest income, which accounts for the main share of total revenue, has underpinned the profitability of the major banks and offset some of the rise in expenses. In the last 12 months, net interest income from domestic operations grew by 28 per cent at the major banks, reflecting balance sheet growth and a recovery in the spread between borrowing and lending rates (Graph 25). Results from the smaller regional banks indicate that net interest income has fallen by 3 per cent in the latest half year, even though their margins seem to have widened slightly in that period.¹

One of the reasons why the Australian banks' earnings have remained comparatively stable is that their business models were focused on domestic lending. As a result, they had relatively little exposure to the kinds of securities that were a significant source of losses in the North Atlantic countries worst affected by the financial crisis. However, provisioning charges for bad and doubtful debts have weighed on profits since 2008. After adjusting for mergers, the major banks reported bad and doubtful debt charges of \$7 billion in their latest half yearly results, compared with \$6 billion in the same period a year earlier (Graph 26). The subsidiaries of foreign banks operating in Australia, which also mainly engage in retail lending, have seen their bad debt charges increase slightly over the year. On the other hand, bad debt charges at regional banks and foreign bank branches appear to have fallen since the first half of 2009, having earlier risen more sharply than those of the major banks.

Despite rising charges for bad and doubtful debts over the latest formal reporting period, commentary by the major banks and equity analysts, in conjunction

1 See Brown A, M Davies, D Fabbro and T Hanrick (2010) 'Recent Developments in Banks' Funding Costs and Lending Rates' RBA Bulletin, March.

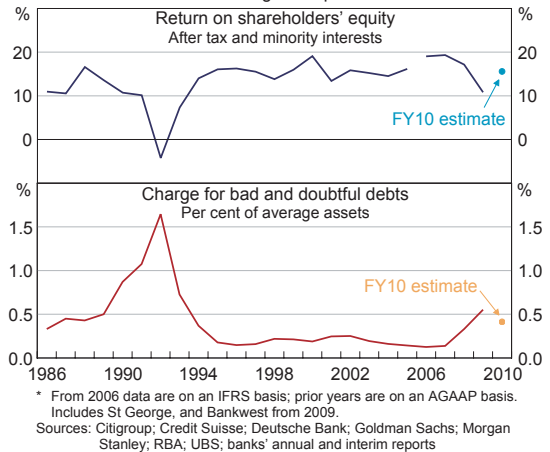
with more timely quarterly data, indicate that the peak in bad debt charges for the major banks occurred in the fourth quarter of 2008 (Graph 27). Analysts therefore generally expect banks' return on equity to increase in the 2010 financial year from a very shallow trough of 11 per cent in 2009.

The ratio of non-performing assets (NPA) to total on-balance sheet assets increased modestly during the period of financial turmoil, but has remained broadly flat at around 1½ per cent since mid 2009 (Graph 28).

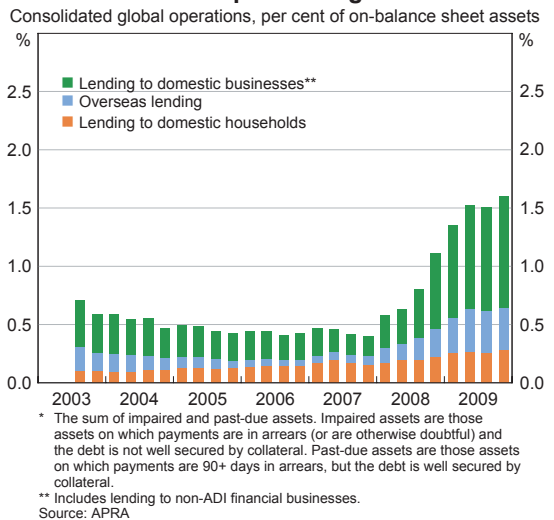
The current deterioration has been much less severe than those of either the early 1990s recession, when the NPA ratio reached more than 6 per cent, or the recent recession in the United States where it was 3 per cent as at the end of 2009. As in the early 1990s, most of the recent increase in the NPA ratio resulted from the pick-up in non-performing loans (NPL) to the business sector. The consequences of this for overall asset quality have been more limited, however. This is partly because the recent economic downturn has been less severe, but also because the banking sector now has a much smaller direct exposure to business lending (at around 40 per cent of total credit outstanding compared with around 60 per cent in the early 1990s). The Australian banks' overseas lending operations recorded larger rises in NPAs than the domestic operations, mainly reflecting the more pronounced deterioration in economic conditions abroad, but this added relatively little to the globally consolidated NPA figures. The very minor deterioration in loans made to the domestic household sector has not materially affected the overall NPA ratio.

With the improvement in economic and financial conditions, the value of assets newly classified as being impaired has stabilised and more customers have tended to revert back to performing status (Graph 29). Banks have also been active in recognising losses, writing off impaired assets from their balance sheets throughout the last two years.

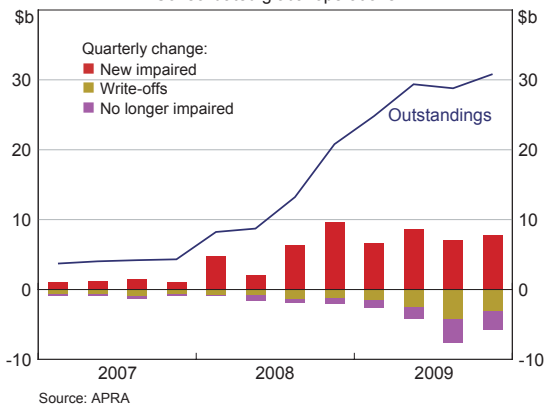
Graph 27
Major Banks' Profitability*
Consolidated global operations



Graph 28
Banks' Non-performing Assets*
Consolidated global operations, per cent of on-balance sheet assets



Graph 29
Banks' Impaired Assets
Consolidated global operations



Banks' commercial property exposures have been an important component of impaired assets and have continued to deteriorate somewhat further over the past six months (Graph 30). Much of the recent rise in impairments has been accounted for by loans to highly geared property developers, many of which were on the books of the smaller Australian-owned banks. These borrowers are often among the first to experience difficulties when financial and/or economic conditions turn for the worse. In order to conserve capital, banks are screening commercial property borrowers more closely, requiring additional

documentation and collateral while also shifting their focus toward higher-quality projects. With the higher cost of funds being passed onto customers, the quantity of loans demanded by property developers has also declined, as some projects have become unviable.

In banks' domestic business loan portfolios, the NPL ratio stood at 3 per cent as at December 2009. This is around 35 basis points higher than six months earlier. The increase in this ratio over recent years was initially driven by a small number of exposures to highly geared companies with complicated financial structures and/or exposures to the commercial property sector. As the economy began to slow in mid 2008, the incidence of non-performing business loans became more broadly based.

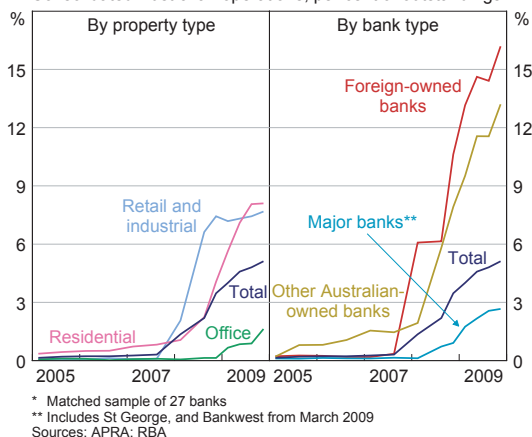
Banks have continued to report very low NPL ratios for their domestic housing loan portfolios – which account for around 60 per cent of aggregate on-balance sheet loans. The NPL ratio for banks' domestic housing lending stood at 0.63 per cent as at December 2009, which is broadly flat over the past six months but up slightly from 0.57 per cent a year earlier. Most of the locally incorporated banks reported a reduction in housing NPL ratios over the second half of the year, reversing the broad-based increases in 2008 (Graph 31). The ratios for credit unions and building societies are lower than for banks; they have also fallen slightly over the past six months, to 0.15 per cent and 0.28 per cent respectively. While recent interest rate rises may raise debt-servicing pressures for some borrowers in the period ahead, more prudent lending criteria should help to limit the share of new customers that would otherwise enter arrears over the medium term (see below).

Consistent with the more difficult economic and financial conditions faced abroad, part of the increase in Australian banks' bad debts has been due to their overseas operations. The overall effect of offshore lending on Australian banks' total NPA has been relatively small because overseas exposures

Graph 30

Impaired Commercial Property Assets

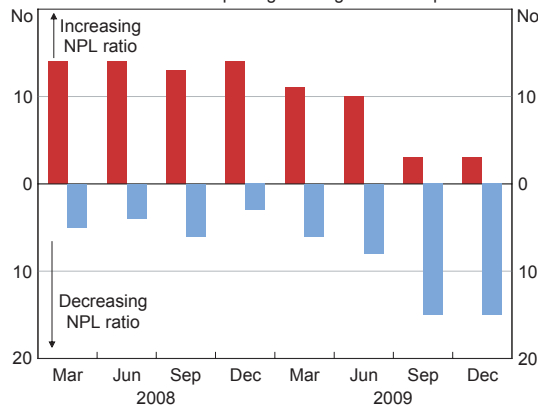
Consolidated Australian operations, per cent of outstandings*



Graph 31

Banks' Non-performing Housing Loan Ratios*

Number of banks reporting a change over the quarter



only account for around one quarter of their assets. In contrast to many overseas banks, the major Australian banks did not aggressively push beyond traditional geographical or product markets over recent years to seek out higher-yielding, but higher-risk, assets. In New Zealand and the United Kingdom – which together account for about two thirds of total foreign exposures – the major banks’ balance sheets also contain a significant share of lending to the traditionally less risky household sector, albeit less than for their domestic operations.

Reflecting their focus on domestic lending, most of the foreign claims of the Australian banks represent their local banking operations in New Zealand and the United Kingdom (Graph 32). They engage in relatively little cross-border lending; this accounts for just 6 per cent of total assets. Given concerns about sovereign credit risk in smaller European countries, it is worth noting that Australian bank exposures to these countries are very small (Table 4). Most of these loans are to the European private non-financial sector and other banks; exposures to the smaller countries in the euro area amount to around ¼ of one per cent of total assets.

Table 4: Australian-owned Banks’ Claims on Europe

Ultimate risk basis, as at end December 2009

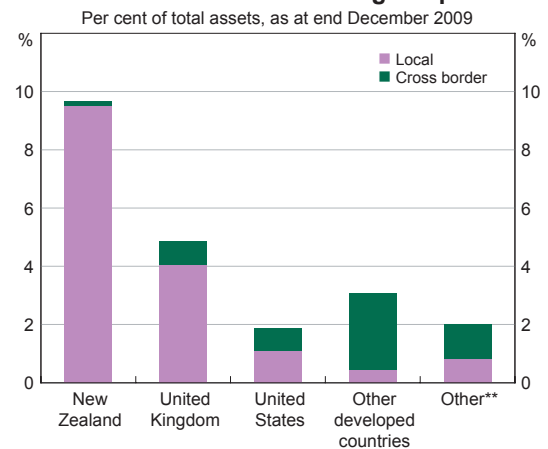
	Total \$ billion
France	11.5
Greece	0.0
Germany	11.0
Ireland	4.1
Italy	12.9
Netherlands	7.7
Portugal	0.5
Spain	3.0
Other countries	5.7
Euro area	56.4

Source: APRA

Capital and Liquidity

The Australian banking system remains well capitalised, with the aggregate Tier 1 capital ratio rising by 0.8 percentage points to 9.4 per cent over the six months to December 2009 (Graph 33).² This ratio is at its highest since at least the late 1980s when comparable data first became available. The

Graph 32
Australian-owned Banks’ Foreign Exposures*



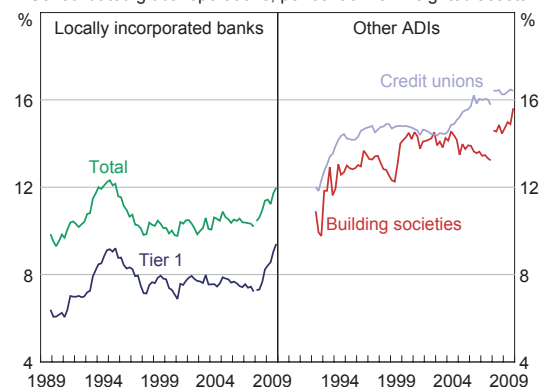
* Ultimate risk basis

** Claims on developing countries, international organisations, offshore centres, and unallocated claims

Source: APRA

Graph 33
Authorised Deposit-taking Institutions’ Capital*

Consolidated global operations, per cent of risk-weighted assets



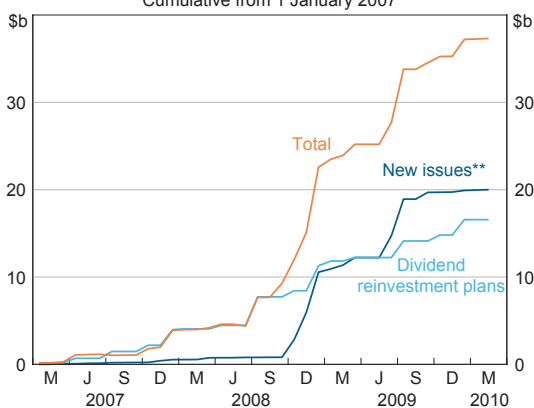
* Break in March 2008 due to the introduction of Basel II for most ADIs

Source: APRA

² Tier 1 capital includes accounting equity items such as ordinary shares and retained earnings, which protect senior creditors from asset losses on a ‘going concern’ basis. Tier 2 capital consists of items such as cumulative preference shares and subordinated debt which, for contractual reasons, only absorb losses on a ‘gone concern’ basis, that is, in a wind-up.

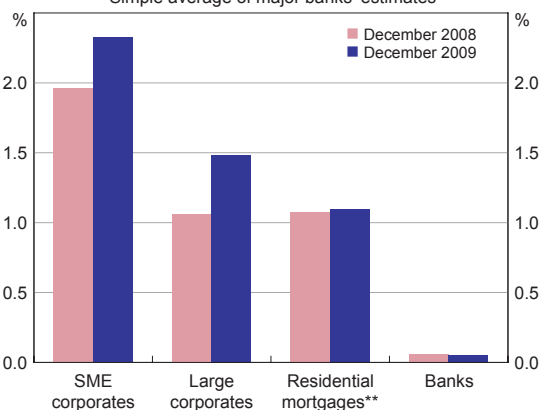
aggregate Tier 2 capital ratio on the other hand has been broadly flat over the past half year. Reflecting these developments, the sector's total capital ratio has risen by around $\frac{3}{4}$ of one percentage point to 12 per cent as at the end of 2009. The credit union and building society sectors are also well capitalised, with aggregate total capital ratios of about 16 per cent. Individual institutions' ratios are well in excess of the prudential capital requirements, reflecting prudent capital management throughout the recent financial turmoil.

Graph 34
Major Banks' Equity Raisings*
 Cumulative from 1 January 2007



* Excludes acquisitions; includes St George
 ** Includes new placements and employee share purchase plans
 Source: ASX

Graph 35
Counterparty Default Probabilities*
 Simple average of major banks' estimates



* 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

The increase in Tier 1 capital in the most recent reporting period builds on earlier increases that have been taking place since around the end of 2007. The cumulative increase was predominantly driven by equity raisings undertaken in late 2008 and the middle of 2009 (Graph 34). The major banks have issued a combined \$37 billion of ordinary equity in this time, largely through a combination of new share issuance and dividend reinvestment plans. The regionals have issued a further \$2 billion over this time. These raisings have seen the share of banking system capital accounted for by ordinary shares rise to almost 50 per cent in December 2009, after this share had declined to around 30 per cent in 2006. Banks have also grown their capital base organically, partly through cuts to dividend payments made to shareholders.

As well as raising new equity and retaining profits, banks' aggregate regulatory capital ratio has been boosted by a decline in risk-weighted assets of 2 per cent over the year to December 2009. The bulk of this decline was driven by a reduction of on-balance sheet corporate credit exposures (as discussed below). However, this was partly offset by an increase in the average risk-weight of these exposures, with the major banks' estimates of the average probability of default for corporate counterparties increasing by around $\frac{1}{2}$ of one percentage point to $1\frac{1}{2}$ per cent over the year to December 2009 (Graph 35). Average default probability estimates for residential mortgages have increased only very slightly and remain around 1 per cent. More generally, recent developments in banks' capital ratios are similar to the experience of the early 1990s, during which banks issued significant amounts of new Tier 1 capital and, at the same time, falls in business credit contributed to a decline in the sector's aggregate risk-weighted assets.

Banks are also holding significantly more liquid assets than they were prior to the onset of the financial market turmoil. Following a step-up in the second half of 2007, the sum of their cash, deposits and highly marketable domestic securities as a share of total domestic liabilities was around 21 per cent in January 2010, or 103 per cent of short-term

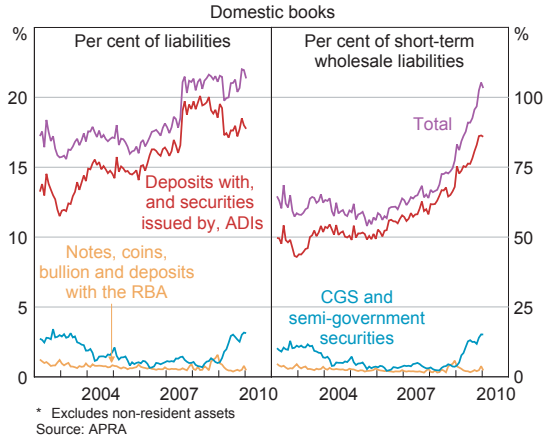
wholesale liabilities (Graph 36). Whereas the bulk of the earlier rise in this ratio reflected increased holdings of securities issued by other authorised deposit-taking institutions (ADIs), the share of liquid assets accounted for by government securities has risen recently from a low base. It is not yet clear what assets will count as high-quality liquid assets for regulatory purposes when revised standards are introduced; the definition of liquid assets is one of the issues still under consideration at the international level by the Basel Committee on Banking Supervision and domestically by APRA (see the *Developments in the Financial System Architecture* chapter).

Financial Markets' Assessment

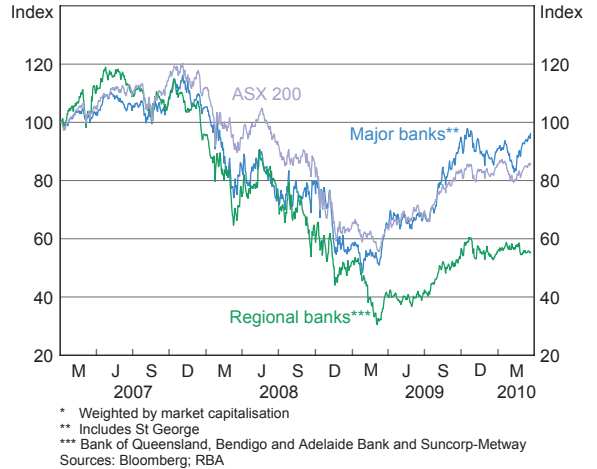
Australian banks' share prices were subject to downward pressure during the worst of the risk aversion in 2008 and early 2009, but subsequently rebounded as financial conditions improved and sentiment towards banks recovered. Bank share prices have been more stable recently, in line with the movement in the broader market (Graph 37). For the major banks, share prices are currently around 20 per cent lower than their 2007 peaks, while share prices of regional banks remain around 55 per cent lower. With market uncertainty having subsided, share price volatility for banks and the market as a whole has declined. The daily movement in banks' share prices has averaged 1½ per cent since September 2009, compared with a significantly higher peak in late 2008.

Australian banks' credit default swap (CDS) premiums – the price paid by investors to insure against the possibility of a credit event such as default on bank debt – have also narrowed significantly since the peak of the crisis. The cost of insuring five-year senior debt of the four major Australian banks is around 80 basis points, well below peaks of over 200 basis points reached in early 2009, but above pre-crisis levels. CDS premiums for large banks in the United States, Europe, and the United Kingdom are higher, at 100 basis points or more.

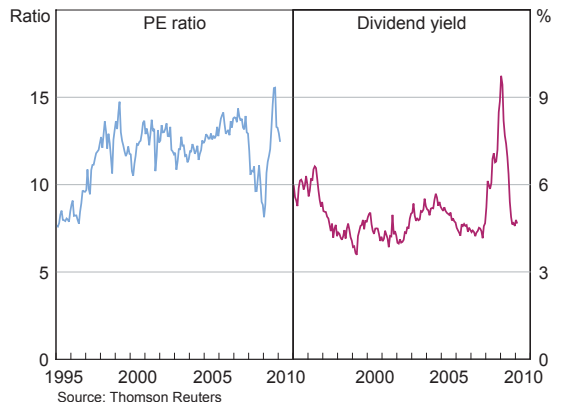
Graph 36
Banks' Liquid Assets*



Graph 37
Banks' Share Prices*
End December 2006 = 100



Graph 38
Indicators of Bank Valuation



The movements in banks' share prices are reflected in market-based valuation measures (Graph 38). The general trend in these measures was to indicate that in 2008 bank share prices were low relative to historical norms as general risk aversion saw shares sold with little discrimination based on profitability or soundness. Subsequently, however, valuation measures have reverted to more normal levels. Banks' forward price-to-earnings (PE) ratio rose quickly as share prices recovered during 2009, but as the earnings outlook firmed, the ratio declined to around its long-run average. Similarly, the dividend yield – the amount paid out in dividends relative to the share price – has reverted back to more normal levels of around 5 per cent, reflecting lower dividends and the earlier rise in share prices.

The largest Australian banks have maintained high credit ratings, consistent with their strong performance and sound capital position. The four major banks' senior debt is rated AA by Standard &

Poor's (S&P). Only six of the other 100 largest banking groups in the world currently have an equivalent or higher credit rating; this has been an important factor in ensuring the major banks' ongoing access to long-term debt markets. S&P and Fitch have the major banks on a stable outlook; Moody's has maintained the negative outlook that it assigned early last year, but currently rates the majors more highly at Aa1. Outside of the major banks, S&P recently affirmed Macquarie Bank's long-term rating of A, and revised up the outlook from 'negative' to 'stable' based on a more positive medium-term financial position. The only Australian-owned bank to have been downgraded by S&P since mid 2008 is Suncorp-Metway (Table 5). However, several subsidiaries of foreign banks have had their ratings lowered, in line with their offshore parents, while National Australia Bank's subsidiary in the United Kingdom was downgraded from AA- to A+ in mid 2009.

Table 5: Long-term Credit Ratings of Banks operating in Australia^(a)
As at 23 March 2010

	Current	Outlook	Last change Direction	Date
AMP Bank	A	Stable	+	April 2008
ANZ Banking Group	AA	Stable	+	February 2007
Arab Bank Australia	A-	Stable	n.a.	January 2007
Bank of Queensland	BBB+	Stable	+	April 2005
Bankwest	AA	Stable	+	December 2008
Bendigo and Adelaide Bank	BBB+	Stable	+	February 2005
Citigroup	A+	Negative	-	December 2008
Commonwealth Bank of Australia	AA	Stable	+	February 2007
HSBC Bank Australia	AA	Negative	+	July 2006
ING Bank (Australia)	A+	Stable	-	September 2009
Macquarie Bank	A	Stable	n.a.	November 1994
Members Equity Bank	BBB	Stable	+	August 2006
National Australia Bank	AA	Stable	+	February 2007
Rabobank	AAA	Negative	+	August 1998
Rural Bank	BBB	Stable	+	August 2007
Suncorp-Metway	A	Stable	-	January 2009
Westpac Banking Corporation^(b)	AA	Stable	+	February 2007

(a) Includes all Australian-owned banks and foreign-owned banks operating in Australia that have an issuer rating from Standard & Poor's

(b) St George Bank has been subsumed by Westpac Banking Corporation and no longer has a separate banking licence or credit rating
Source: Standard & Poor's

Funding Conditions and Government Guarantee Arrangements

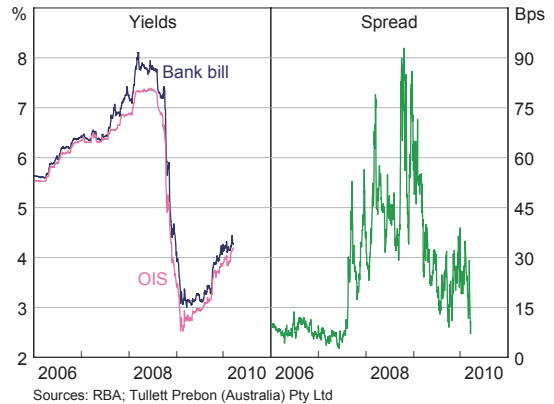
As financial market conditions have become less stressed, funding conditions for Australian lenders have also recovered. General access to markets has improved and the cost of wholesale funding has fallen as the severe risk aversion which spilled over into global capital markets from the North Atlantic financial crisis countries abated. Accordingly banks have substantially reduced their use of the liquidity support offered by the Reserve Bank through its domestic market operations and issued less Australian Government guaranteed debt. Instead, banks have increasingly issued unguaranteed debt. As a result of the improved conditions, the Treasurer recently announced the closure of guarantee arrangements for wholesale debt to new borrowing. However, competition for deposits remains intense.

Interest rates in domestic money markets have risen from their multi-decade lows, while spreads on three-month bank bills to the three-month overnight swap rate (OIS) have tightened by around 80 basis points since their peak in late 2008 (Graph 39). Since the previous *Review*, spreads have continued to be volatile but have remained well below the peaks reached in the crisis period. Current spreads are generally higher than in the immediate pre-crisis period, but that was a period when risk was generally being underpriced.

There has been considerably less demand for the facilities made available through the Reserve Bank's domestic market operations since the crisis peak in late 2008 (Graph 40). As noted in the previous *Review*, balances held as term deposits or exchange settlement accounts at the Reserve Bank ran down quite quickly over the first half of 2009. And as the extreme shortage of US dollars in international markets eased, there was a fairly rapid run-down of balances outstanding under swap arrangements with the US Federal Reserve over the same period.

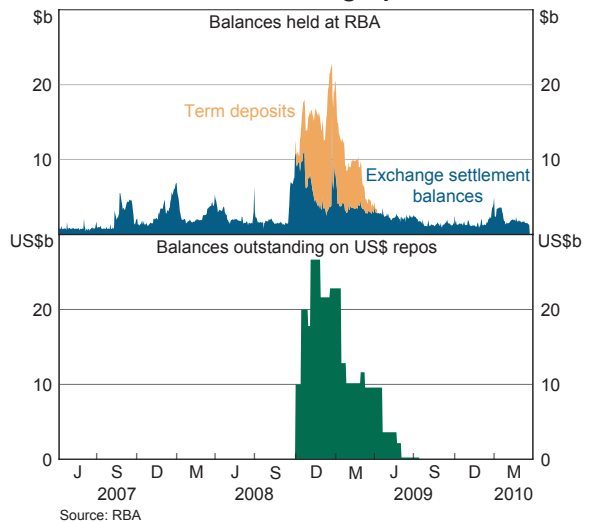
Graph 39

3-month Interest Rates



Graph 40

Reserve Bank Dealing Operations

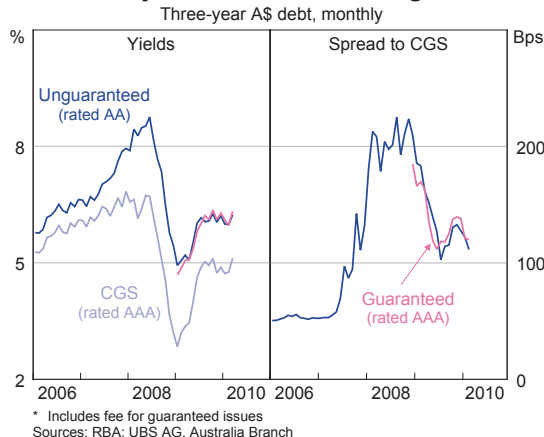


In line with these developments, the Reserve Bank judged it appropriate to scale back the support to the financial system that was warranted during the worst of the spill-over in risk aversion. The only new development since the last *Review* has been that the Reserve Bank allowed the level of exchange settlement balances to rise in late December 2009 to address some year-end funding pressures, but otherwise balances have generally remained between \$1½–2 billion.

Conditions in both domestic and offshore long-term bank debt markets have also markedly improved from late 2008 and early 2009. Domestic secondary market spreads on the major banks' three-year unguaranteed bonds, for instance, have fallen by around 70 basis points to around 110 basis points over Commonwealth Government Securities (CGS) in the past 12 months (Graph 41). Spreads in a number of markets have narrowed sufficiently

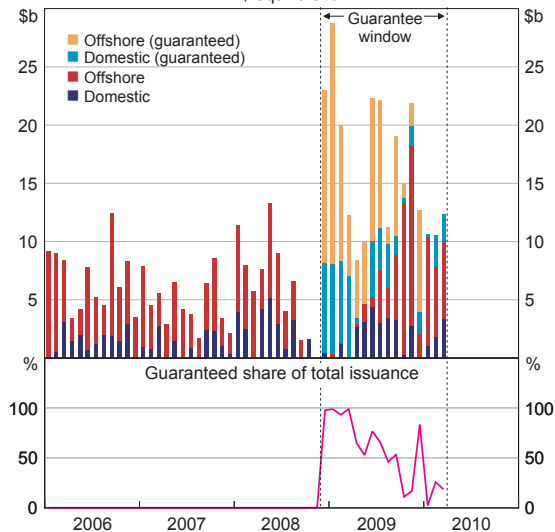
for it to be cheaper for highly rated banks to issue unguaranteed bonds than to pay the 70 basis point guarantee fee. As a result, the share of issuance under the guarantee arrangements fell significantly and was close to zero by the beginning of this year (Graph 42). More recently, there has been some renewed issuance of guaranteed debt, mainly by smaller banks, prior to the Scheme's closure (see below). Outstanding guaranteed short-term debt and large deposits (greater than \$1 million), which are considerably less than guaranteed long-term funding, are well off their peaks, having fallen since early in 2009 as risk aversion has abated. The current amount outstanding under the Guarantee Scheme is \$169 billion.³

Graph 41
Major Banks' Bond Pricing*



Reflecting the improved funding conditions, and the closure of guarantee arrangements in a number of countries, the Council of Financial Regulators advised the Australian Government that the local guarantee arrangements were no longer required. Subsequently, the Treasurer announced in early February that the Guarantee Scheme for Large Deposits and Wholesale Funding would be closed to new borrowings as at the end of March 2010. Existing guaranteed liabilities will continue to be covered by the Scheme to maturity for wholesale funding and term deposits, or to October 2015 for at-call deposits. Deposits under \$1 million will continue to be guaranteed separately under the Financial Claims Scheme (refer also to *Developments in the Financial System Architecture*).

Graph 42
Australian Banks' Bond Issuance*



Banks have issued \$177 billion of long-term debt over the past 12 months, including the debt covered by the Scheme.⁴ This is significantly more than their aggregate issuance of \$92 billion in 2008, and well above issuance of \$58 billion in 2007. Most of the recent issuance has been into offshore markets and is mainly denominated in US dollars (though swapped back to Australian dollars – see also *Box B*:

3 For a detailed review of the guarantee arrangements see also Schwartz C (2010) 'The Australian Government Guarantee Scheme', RBA Bulletin, March.

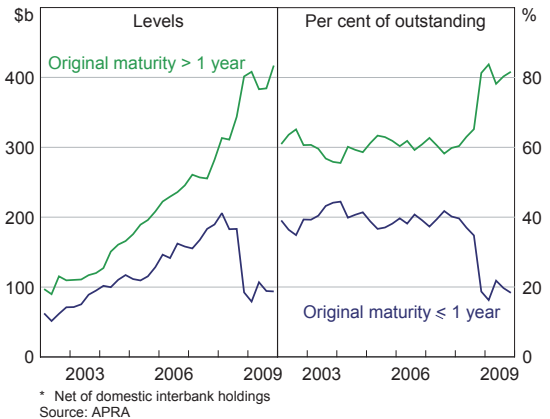
4 See also Black S, A Brasil and M Hack (2010) 'Recent trends in Australian Banks' Bond Issuance', RBA Bulletin, March.

Foreign Currency Exposure and Hedging Practices of Australian Banks). Another development has been that the issuance of Australian dollar denominated bonds by foreigners has recovered somewhat. As a result the natural counterparties to the banks' foreign exchange hedging transactions have returned to the market and the cost of swapping debt back into Australian dollars has narrowed a little.

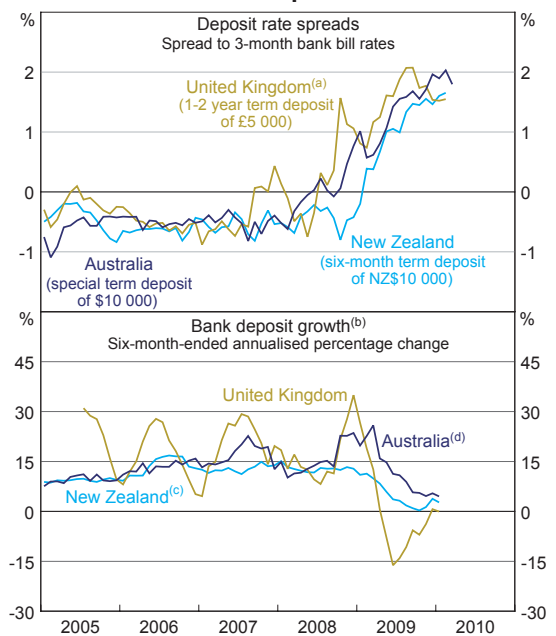
To some extent, the relatively strong bond issuance over the past 12 months reflects banks' increased funding requirements. They have undertaken the financing of a larger share of household mortgages lately, offsetting the decline in lending by mortgage originators following the dislocation in securitisation markets. It also reflects banks seeking to lengthen the maturity profile of their liabilities in response to increased focus on funding and liquidity risk. Accordingly, the share of banks' outstanding wholesale debt with an original maturity of more than one year has increased from around 60 per cent in June 2008 to around 80 per cent in December 2009 (Graph 43).

Also reflecting a focus on what is perceived to be a more stable source of funds, banks have continued to compete vigorously for deposits by offering higher interest rates, particularly on term deposits. 'Special' term deposit rates offered by the major banks are now 180 basis points above the three-month bank bill rate, compared with a spread of around 75 basis points at the end of December 2008, and typically negative spreads prior to the crisis (Graph 44). Competition for deposits is also strong in the major banks' other key markets, with deposit spreads having increased in both New Zealand and the United Kingdom. Banks also appear to be competing for deposits by cutting fees. The largest banks have reduced their exception fees for deposit accounts – which are charged when the terms of a banking product are breached – and a few banks have introduced deposit accounts that reimburse the fee for withdrawing money from some other banks' ATMs.

Graph 43
Banks' Non-intermediated Debt*
Domestic books



Graph 44
Bank Deposits



(a) Spread is to the UK one-year swap rate.
(b) Data are seasonally adjusted and adjusted for some series breaks. Excludes certificates of deposit. Foreign currency deposits are excluded for Australia and New Zealand, but are included for the United Kingdom.
(c) Household deposits only.
(d) Includes deposits from large credit unions and building societies.
Sources: APRA; Bank of England; Bloomberg; RBA; RBNZ

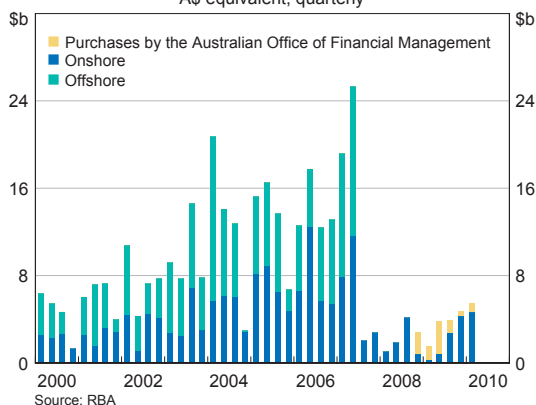
While deposits with ADIs in Australia continue to rise, their growth has slowed markedly from the very rapid rates in 2008. Over the six months to January 2010, total deposits in Australia increased at an annualised rate of 4½ per cent, which is broadly in line with growth in the major banks' other key markets, but well below growth rates of around 25 per cent seen in late 2008 and early 2009. The slowing in domestic deposit growth reflects a combination of slower overall balance-sheet growth and the fact that deposit growth in 2008 had been boosted by the shift away from riskier asset classes occurring at that time. The heightened competition for deposits has

added to banks' average funding costs relative to the cash rate.

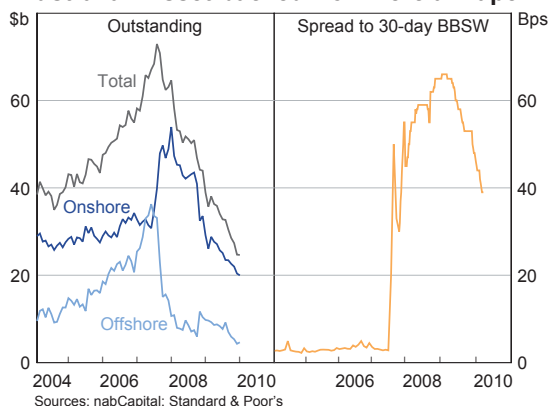
As with other wholesale markets, Australian securitisation markets have also shown signs of improvement, although spreads remain considerably wider than before the market turmoil began. Secondary market spreads on AAA-rated residential mortgage-backed securities (RMBS) tranches have fallen by 240 basis points over the past 12 months, to 140 basis points above the three-month bank bill swap rate. In mid 2007, by comparison, it was possible to sell AAA-rated RMBS at spreads of around 15 basis points. Issuance of these instruments totalled \$14 billion in 2009, which represents a noticeable pick-up from the \$10 billion of issuance in 2008, but is still well down on the \$50 billion issued in both 2006 and 2007 (Graph 45). Around half of RMBS issuance in 2009 were purchased by the Australian Office of Financial Management (AOFM), though the participation of private investors increased through the year. Issuance has strengthened further in the early part of 2010. Losses on prime RMBS (after proceeds from property sales) continue to be fully covered by credit enhancements such as lenders' mortgage insurance, and no losses have been borne by investors in a rated tranche of an Australian RMBS.

Conditions in shorter-term securitisation markets have also improved, reflected in declining spreads on asset-backed commercial paper (ABCP). Since their peak, ABCP spreads have fallen by almost 30 basis points, to be around 40 basis points above the one-month bank bill swap rate (BBSW) (Graph 46). While market participants report that they continue to have little difficulty rolling over paper, the amount of ABCP outstanding continues to decline, falling to \$25 billion in December 2009. This reflects 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 45
Australian RMBS Issuance
A\$ equivalent, quarterly



Graph 46
Australian Asset-backed Commercial Paper



Lending Growth and Credit Conditions

In aggregate, Australian banks continued to grow their domestic loan books over the past six months, as they have been less constrained by the need to repair balance sheets than was the case in some other countries. Yet there has been a notable slowing in credit growth since late 2007 as weakness in the financial and real sectors abroad began to affect Australian economic conditions (Graph 47).

Domestic business credit contracted between early 2009 and early 2010, with falls reported across most bank and non-bank lenders. Bank business credit fell at an annualised rate of 10 per cent over the six months to January 2010, although the decline appears to be coming to an end; the most recent monthly figures show the amount of business credit outstanding being broadly flat. Part of the reason for the fall in business credit over the past year is that demand for intermediated debt has been weak. As discussed in more detail in the *Household and Business Balance Sheets* chapter, companies have raised a greater share of their funding from equity markets following the crisis and some have paid down debt to reduce their leverage. Some larger corporates have also recently issued debt in wholesale markets, after this source of funding had dried up in late 2007 and they had increasingly been forced to roll-over debt by resorting to bank loans. As financial conditions improve further, some of that shift to bank financing is now reversing.

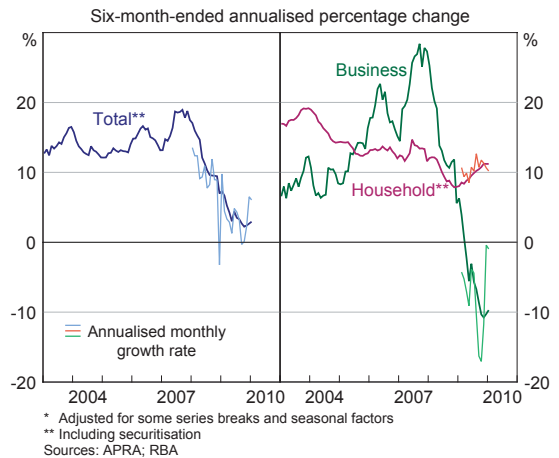
On the supply side, banks have also tightened the terms and conditions under which they are willing to extend credit to businesses and households. This contrasts with the easing in standards seen in earlier years, and reflects the banking sector's response to a perceived increase in the probability of default among most categories of borrowers. As these risks have risen, banks have sought to conserve capital by directing their lending towards

less risky ventures. Over the past couple of years, banks have generally also raised risk margins and strengthened non-price loan conditions, such as collateral requirements and loan covenants.

All types of banks have curtailed the business credit they extend, but this has been most pronounced among the foreign-owned banks (Graph 48). The activities of these banks had been one of the factors driving the previous strong growth in business lending, particularly in the larger-value segment where they had made notable gains in market share over recent years. While a small number of institutions have recently pulled back from the

Graph 47

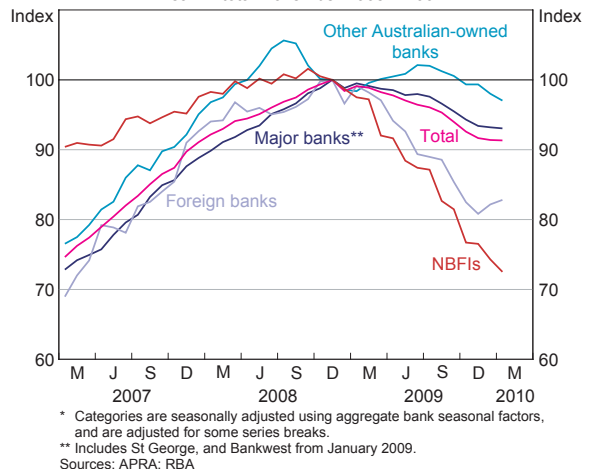
Bank Credit*



Graph 48

Business Credit*

Peak in total November 2008 = 100



domestic market, there has been little evidence of a generalised withdrawal. Foreign-owned banks have, on balance, continued to participate in recent syndicated loan deals, just as they did throughout the turmoil period, and in the past couple of months their overall lending has begun to pick up. At the same time, credit extended by the major banks has stabilised over recent months, and these banks have generally increased their lending to smaller unincorporated businesses over the past year.

In contrast to business credit, bank lending to households has remained resilient, and is currently growing at an annualised rate of 11 per cent over the six months to January 2010, compared to 10 per cent over the six months to July 2009 (refer back to Graph 47). This is faster than overall household credit growth, as lending by non-banks has been softer. Lending growth over 2009, much of which had been to first-home buyers in the first half of the year, has occurred against a backdrop of more stringent lending standards at most lenders. There has been some further reduction in maximum loan-to-valuation ratios (LVR) over the past six months, with most of the largest lenders

no longer offering new customers loans with LVRs greater than 90 per cent. Likewise, banks have paid closer attention to other sources of credit risk, particularly among first-home buyers where lenders now typically require minimum 'genuine savings' of 5 per cent.

The major banks have continued to drive the growth in housing lending. They accounted for around 80 per cent of new owner-occupier loan approvals at the end of 2009, compared to around 60 per cent in mid 2007. In contrast, lenders that had previously relied more heavily on securitisation for funding – such as wholesale lenders and the smaller Australian-owned banks – continued to account for a lower share of loan approvals than they did in mid 2007. Credit unions and building societies' current share of new owner-occupier loan approvals is broadly similar to what it was at the beginning of 2008, following some small gains over recent months.

General Insurance

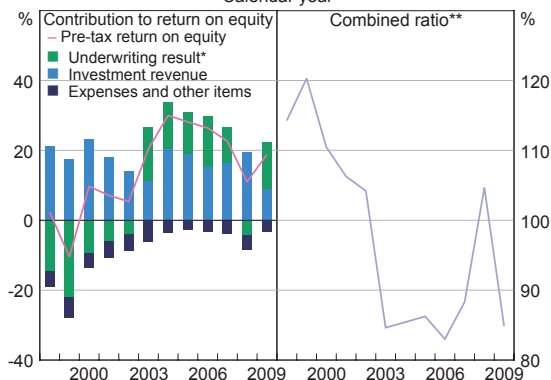
General insurers remained profitable throughout the financial turmoil. The Australian insurance industry reported overall post-tax profits of \$4 billion in the year to December 2009, compared with around \$2 billion in the previous year. The pre-tax return on equity was 19 per cent in the latest year, in line with the 10-year average (Graph 49). These results were underpinned by stronger underwriting returns, after insurers recorded losses on these operations in 2008. Reflecting this, insurers' aggregate combined ratio – claims and underwriting expenses relative to net premium revenue – fell to 85 per cent in 2009, consistent with ratios reported between 2003 and 2006.

Underlying this result was a rise in net premium revenues. Part of this growth was attributable to rising premium rates (particularly in personal lines), as insurers adjusted prices in response to an increase in claims related to storms and bushfires in 2008

Graph 49

Performance of General Insurers

Calendar year



* Premium revenue (net of reinsurance expenses) minus claims and underwriting expenses
 ** Claims and underwriting expenses as a per cent of premium revenue (net of reinsurance expenses)
 Source: APRA

and early 2009 (Graph 50). There had also been an increase in insurers' measured claim liabilities over 2008 arising from a reduction in risk-free interest rates (which are used to discount expected future claim payments). Claim expenses declined by almost 20 per cent in 2009, as risk-free rates rose over the year and insurers benefited from the absence of any major claim events in the second half of the year. Only \$7 million of estimated insured catastrophe losses were incurred in the six months to December, compared with insured catastrophe losses of \$1.1 billion (including from the Victorian bushfires and floods in Queensland) in the first half of the year.

Partly offsetting improved underwriting performance, returns on invested premiums were around 50 per cent lower in 2009. This was partly because prices on fixed-income securities declined in response to rising yields on benchmark securities; interest income on investments was also lower following the sharp decline in the cash rate in late 2008. General insurers are likely to have benefited only a little from the strong rise in equity prices over the past year; investments in equities accounted for less than 5 per cent of their investment assets as at December 2009, with the majority of assets being interest-bearing.

The general insurance industry remains soundly capitalised, with the industry holding capital equivalent to almost double the regulatory minimum as at September 2009 (the latest available data). Several of the large insurers

have strengthened their capital positions by raising a combined \$625 million in equity since mid last year. The four largest Australian insurers generally maintained high credit ratings throughout the financial turmoil, and are currently rated A+ or higher by S&P with stable rating outlooks (Table 6). One small insurer (Australian Family Assurance Limited), however, was declared insolvent by APRA in 2009, and eligible claims made on this insurer before October 2010 will be covered by the Government under the Financial Claims Scheme: Policyholder Compensation Facility. This insurer had been authorised to conduct only run-off business since 2000 – not taking any new business – and its failure was due to company-specific events, rather than broader developments in financial and economic conditions.

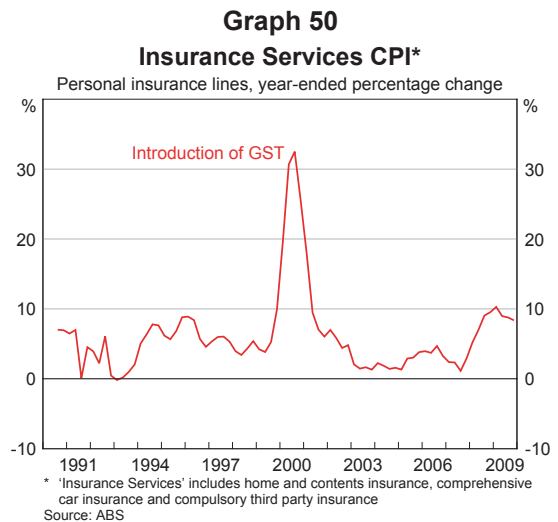


Table 6: Financial Strength Ratings of Large Insurers
As at 23 March 2010

	Current	Outlook
Allianz Australia Insurance	AA-	Stable
Insurance Australia Group	AA-	Stable
QBE Insurance Australia	A+	Stable
Suncorp-Metway Insurance	A+	Stable

Source: Standard & Poor's

The share prices of the largest listed Australian general insurers have lagged behind the major banks but recovered around 40 per cent from their low point in March 2009 (Graph 51). Consistent with a general abatement of risk aversion, general insurers' CDS premiums have fallen from their early 2009 peaks, to be around 90 basis points, slightly above the broader market average.

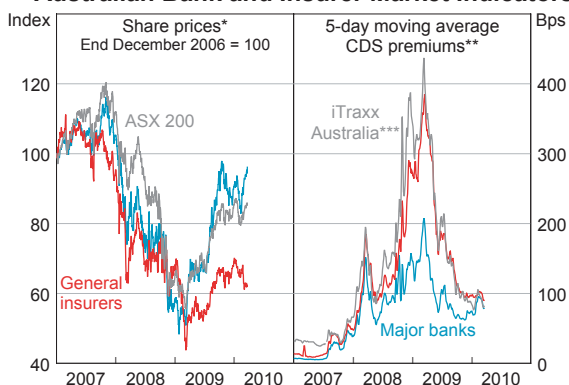
A significant share of Australian insurers' reinsurance cover is provided by several of the large global reinsurers, which in the latest year reported a rise in profits, and as at December 2009 held capital

in excess of the regulatory minimum. Despite a recent decline in the price of reinsurance – related to improving supply because of a strengthening in reinsurers' balance sheets – analysts expect the global reinsurance industry to record solid profits in the year ahead. Several of the largest reinsurance companies have generally maintained high credit ratings over the past year and, at present, are rated A+ or higher by S&P.

Unlike their US peers, the two largest providers of lenders' mortgage insurance (LMI) in Australia – QBE and Genworth – experienced a slight decline in mortgage arrears over the past year. These insurers also benefited from earlier measures taken to tighten their underwriting standards – such as lowering the maximum LVR for loans that they will cover, and the introduction of 'genuine savings' requirements – as well as previous rises in premium rates. Reflecting this, the Australian mortgage insurance operations for QBE and Genworth reported solid profits in 2009, and they are currently rated AA- by S&P with stable outlooks.

Graph 51

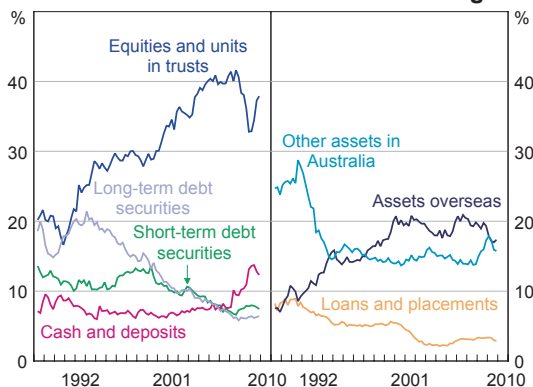
Australian Bank and Insurer Market Indicators



* Market-capitalisation-weighted indices. 'Major banks' includes St George; 'general insurers' are IAG, QBE and Suncorp-Metway.
 ** Senior 5-year CDS premiums. 'Major banks' excludes St George from 1 December 2008.
 *** Break in series due to change in data source.
 Sources: Bloomberg; JPMorgan; RBA

Graph 52

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

The Australian funds management industry continued to benefit from the recovery of financial asset values over much of 2009. Domestic funds under management increased at an annualised rate of 23 per cent over the six months to December 2009, mainly due to the stronger performance of superannuation funds and life insurers (Table 7). Much of the increase in assets reflected valuation changes attributable to a rebound in equity markets rather than new inflows into these funds. Consistent with this, the share of funds invested in domestic equities and units in trusts increased from 33 per cent to 38 per cent over the year to December 2009, though this is still below the mid-late 2007 peak (Graph 52). In contrast, overall holdings of cash and deposits were little changed over this period; although their share of funds under management remains near the peak, they represent only 12 per cent of the total.

Table 7: Domestic Funds under Management^(a)
December 2009

	Level \$billion	Share of total Per cent	Six-month-ended annualised change	
			Jun 09 Per cent	Dec 09 Per cent
Superannuation funds (consolidated)	846.2	63.4	10.9	31.6
Superannuation funds (unconsolidated)	1 019.7		12.6	31.1
<i>of which:</i>				
<i>Cash and deposits</i>	161.7	15.8	21.7	1.2
<i>Loans and placements</i>	9.8	1.0	14.8	28.9
<i>Short-term securities</i>	52.9	5.2	21.3	43.9
<i>Long-term securities</i>	56.0	5.5	1.8	34.0
<i>Equities</i>	323.0	31.7	25.8	55.3
<i>Units in trusts</i>	152.1	14.9	20.7	33.4
<i>Other assets in Australia^(b)</i>	97.8	9.6	15.7	9.6
<i>Assets overseas</i>	166.4	16.3	-18.3	32.7
Life insurers^(c) (consolidated)	182.0	13.6	-2.7	25.0
Public unit trusts (consolidated)	259.4	19.4	-5.1	8.3
Public unit trusts (unconsolidated)	296.5		-4.9	15.0
<i>of which:</i>				
<i>Listed property trusts</i>	122.6	41.4	-4.1	-0.4
<i>Listed equity trusts</i>	46.3	15.6	-10.3	-10.9
<i>Unlisted equity trusts</i>	99.3	33.5	-1.1	70.5
<i>Other trusts</i>	28.3	9.5	-8.2	-1.8
Other managed funds^(d) (consolidated)	47.9	3.6	-14.2	-23.0
Total (consolidated)	1 335.5	100.0	4.1	22.9
<i>of which:</i>				
All superannuation assets ^(e)	1 008.8	75.5	8.7	31.0

(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

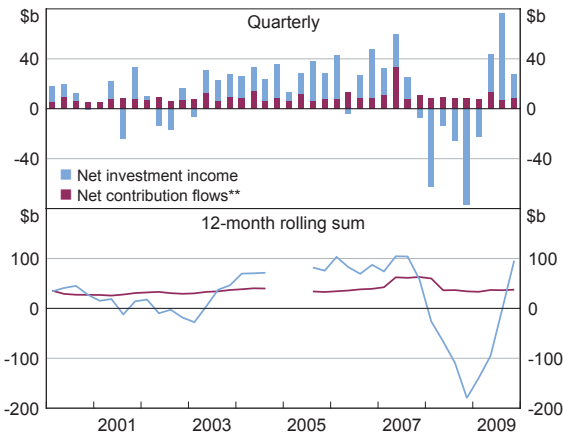
(d) Cash management trusts, common funds and friendly societies

(e) Superannuation funds plus an estimate of the superannuation assets held in the statutory funds of life insurers

Sources: ABS; RBA

Graph 53

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

Superannuation funds recorded gains on their investment portfolios of almost \$96 billion in the year to December 2009, partly offsetting losses of around \$180 billion recorded in the previous year (Graph 53). Inflows to superannuation funds have also picked up a little in recent months, and are broadly in line with net contributions observed in previous years.

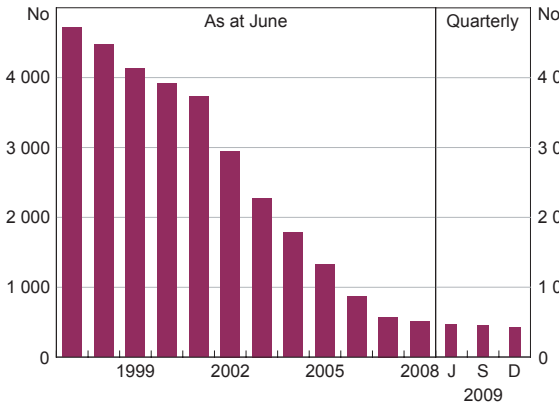
The superannuation industry's long-run trend of consolidation has continued, with the number of APRA-regulated funds (that have more than four members) falling from 505 to 429 since 2008 (Graph 54).

Life Insurers

Life insurers' consolidated assets rose at an annualised rate of 25 per cent over the six months to December 2009, after having declined over 2008 and early 2009. Most of this rise reflected valuation gains on superannuation assets held in life offices, which account for around 90 per cent of life insurers' aggregate assets. Life insurers recorded aggregate investment revenues of around \$27 billion in the six months to September 2009 (the latest available data), compared with investment losses of \$24 billion in the half year to March (Graph 55). However, because much of these recent investment gains were attributable to the insurers' policyholders rather than their shareholders, the net effect on profits was much smaller, with aggregate post-tax profits rising to \$1½ billion in the half year to September 2009. Profits were also supported by stronger direct premium revenues, which rose by around 12 per cent in the year to the September quarter 2009, indicating that demand for more traditional life insurance products has strengthened. Consistent with their higher profits, life insurers improved their capital position over the past year, on average, and held capital equivalent to around 1½ times the regulatory minimum as at September 2009.

Graph 54

APRA Regulated Superannuation Funds
 Funds with more than four members



Source: APRA

Superannuation Funds

Superannuation funds' (consolidated) assets under management rose at an annualised rate of around 30 per cent over the six months to December 2009, to be 21 per cent higher over the past year. This pick-up was due to stronger growth in most asset classes, particularly in domestic equities and units in trusts, which accounted for about one half of total (unconsolidated) superannuation assets as at December.

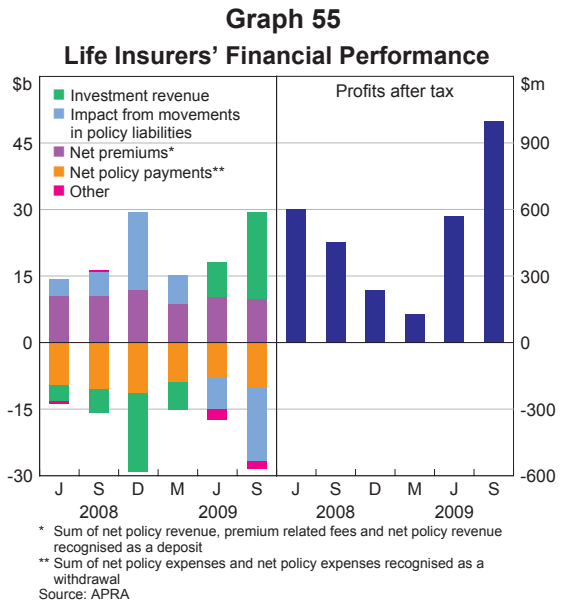
Public Unit Trusts and Other Managed Funds

Outside of superannuation funds and life offices, much of the remaining funds under management are invested in public unit trusts. On a consolidated basis, public unit trusts' assets rose at an annualised rate of around 8 per cent over the six months to December 2009, to be 1½ per cent higher over the past year. While assets in listed equity trusts declined over the half year to December, they remained stable for listed property trusts, and rose strongly for unlisted equity trusts. Despite this increase, unlisted equity trusts' assets remain around 20 per cent below their late 2007 peak.

As noted in previous *Reviews*, the mortgage trust industry was also affected by developments in financial markets and the broader economy, with many trusts experiencing an outflow of funds. Given the illiquidity of their underlying assets, most open-end pooled mortgage funds ceased paying redemptions on request. More recently, some funds have offered investors the option to make partial withdrawals, funded from available cash. To improve investor access to frozen funds, the Australian Securities and Investments Commission (ASIC) had previously introduced provisions which allow fund operators to satisfy withdrawal requests from investors experiencing acute hardship, in priority to other investors. In December 2009, further relief measures were announced which allow for more streamlined and equitable withdrawal arrangements to be put in place as cash becomes available within frozen mortgage and property funds. As at January 2010, Australian mortgage trusts' funds under management were around 30 per cent below their mid 2007 peak.

Market Infrastructure

The payment system infrastructure continued to perform well through the crisis period, although settlements and clearing-house operations were

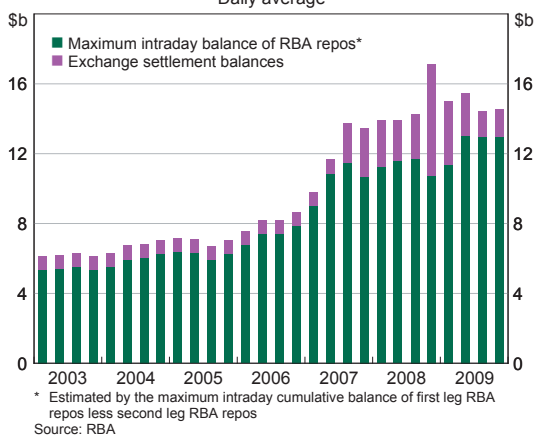


affected in a number of ways by heightened aversion to risk. Participants demanded increased liquidity buffers and other safeguards, and central banks around the world, including the Reserve Bank, responded to these conditions by expanding their domestic liquidity operations. As conditions have improved, there has been less need for support, which is reflected in the decline in exchange settlement balances the banks hold at the Reserve Bank. The volume of transactions processed by clearing and settlement facilities fell with the general decline in underlying financial market activity during the crisis period, but has largely recovered since.

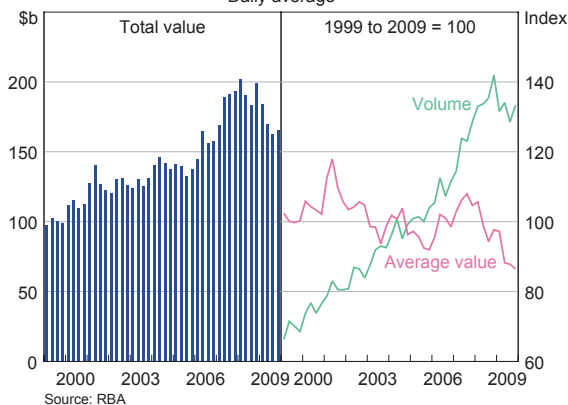
In Australia, high-value transactions settle on a real-time gross settlement basis through the Reserve Bank Information and Transfer System (RITS). Efficient operation of the payment system requires participants to hold sufficient cash at the Reserve Bank to meet their payment obligations. When market conditions are stable, the aggregate demand for cash balances is typically small. Conversely, uncertainty is reflected in increased demand for cash balances held with the central bank. Following the collapse of Lehman Brothers

in September 2008, daily overnight exchange settlement balances peaked at \$16 billion but have since declined to around \$1½ billion (Graph 56 and Graph 40). This reduction has more than offset an increase in the value of intraday repurchase transactions (repos) undertaken with the central bank over recent quarters. Observable system liquidity – measured as the sum of daily overnight exchange settlement balances and maximum intraday repos with the Reserve Bank – is off its late-2008 peak but remains higher than levels prevailing earlier in the decade.

Graph 56
Observable System Liquidity in RITS
 Daily average



Graph 57
RITS Settled Payments
 Daily average



RITS continues to operate smoothly with orderly settlement activity underpinned by ample system liquidity. There are emerging signs in the data that settlement activity, which slowed during 2008 and 2009, may be picking up. Nevertheless, average daily settlements remain nearly 17 per cent below the 2008 peak in value terms, and 6 per cent lower in volume terms (Graph 57). The average transaction size declined as larger-value transactions (over \$100 million) fell more sharply than smaller-value transactions during the market turmoil.

Additional system liquidity and fewer large-value payments have allowed a greater proportion of settlements to occur earlier in the day. On average in 2009, 50 per cent of daily settlement values were completed by 13:45, an hour earlier than in 2007, at which time there was a more discernable peak in settlement activity that occurred late in the day (Graph 58). There has been no indication since the onset of the crisis period of more regular disruptions to settlement activity or operational discontinuities that have required more frequent extensions to RITS operating hours or greater recourse to the Reserve Bank's overnight repo facility.

Clearing of transactions in equity and derivative markets is conducted by two central counterparties, the Australian Clearing House (ACH) and SFE Clearing Corporation (SFECC). Transactions between buyers and sellers in these markets are 'novated' to the respective clearing houses, a process whereby one contract between two initial counterparties is replaced with two new contracts, one between each contracting party and the clearing house. Novation exposes the central counterparty to risk in the event of a participant's default, and this is typically provisioned for by a combination of margins and other risk management tools.

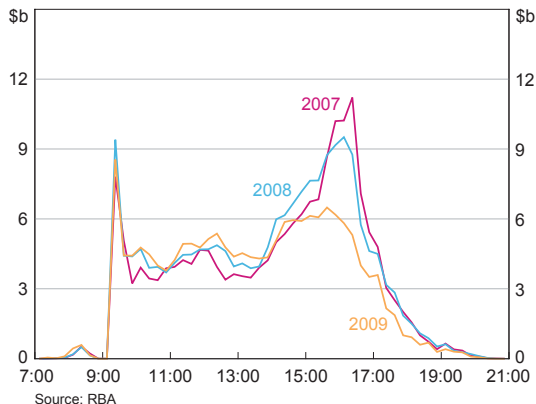
Despite growth in overall activity in the half year to December 2009, the scale of risk exposure assumed by the clearing houses supporting the equities and derivatives markets has declined. One measure

of such exposures is the value of margin held by the central counterparties against participants' positions in derivatives markets. Less volatile markets have led to a reduction in initial margin intervals, and the value of initial margins held has declined (Graph 59). Mark-to-market margin has similarly declined.

The central counterparties also monitor credit risk and maintain a 'watch list' of participants deemed to warrant more intensive monitoring. An improvement in financial conditions has reduced the number of participants on the ACH watch list to one as at the end of December 2009 from a peak of 15. No participant remains on SFECC's watch list.

There were no noteworthy settlement issues arising from clearing house activity in the second half of 2009. The average rate of failed securities settlements remained low at around ½ of one per cent of total settlements. Because of the complexities involved in aligning securities delivery in a global market, some rate of failure is common to all equity clearing and settlement systems, but Australia remains at the low end of international comparisons.

Graph 58
RITS Settled Payments
15-minute intervals



Graph 59
Initial Margin

