Financial Stability Review

SEPTEMBER 2011

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Financial Stability Review enquiries

Information Department
Telephone: (612) 9551 9830
Facsimile: (612) 9551 8033
E-mail: rbainfo@rba.gov.au

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Overview

Market concerns about sovereign debt sustainability in Europe have escalated over the past six months and spread to a wider range of countries in that region. Severe market reactions to sovereign credit risk have impinged on funding markets for euro area banks; in particular, US dollar funding pressures have re-emerged in recent months. These funding strains are compounding the difficulties some of these banks already faced from weak economic growth. As a result, a number of euro area banks have become more reliant on central bank liquidity support. Spillovers to bank funding markets outside the euro area have, however, been relatively limited so far.

The sovereign debt problems, together with a reassessment of European and US growth prospects, have raised risk aversion, and helped trigger a period of heightened turbulence in global financial markets since early August. Associated with this, share prices of financial institutions have fallen sharply in most major markets, but particularly in the euro area. While the latest market strains have not been on the same scale as 2008–09, it is difficult to tell at this stage whether this will be another temporary bout of market uncertainty, of the kind seen several times in the past few years, or the beginning of a more serious market dislocation. Much will depend on the ability of governments, especially in Europe, to resolve the sovereign debt problems affecting some countries.

Compared with the pre-crisis period, the major banking systems should be better positioned to cope with a period of renewed market stress. Most large banks in the major advanced countries have strengthened their capital and funding positions over recent years. While banks in Europe are carrying significant aggregate exposures to debt of the sovereigns whose creditworthiness has declined, there is less uncertainty about problem exposures than there was during the 2008 crisis. This is partly because sovereign bonds are less complex than the structured securities that sparked the crisis, and partly because recent supervisory stress test results provided detailed data to markets about those exposures. These differences should help to limit any contagion effects compared with those seen during 2008–09.

Most large banks have continued to report profits in the recent period, though overall returns on equity remain below pre-crisis averages. Many banks are, however, still dealing with elevated levels of non-performing loans, particularly property-related loans, and their loan-loss provisioning is no longer declining rapidly from the peaks seen during the crisis. The difficult macro-financial environment in the major economies will continue to affect the outlook for banks' asset quality and profitability.

The Australian banking system remains in a relatively strong condition compared with some overseas. The recent global market turbulence has contributed to falls in Australian banks' share prices and some tightening in wholesale funding conditions, but the overall effect has been modest compared with the experience in 2008–09 or with some other countries currently. The Australian banking system is considerably better placed to cope with periods of market strain than it was before the crisis, having

substantially strengthened its liquidity, funding and capital positions in recent years. Growth in bank deposits is continuing to outpace growth in credit, and the major banks are ahead of schedule on their term wholesale funding plans. Profitability for the major banks has continued to increase to around pre-crisis levels, mainly due to further declines in charges for bad and doubtful debts. However, the scope for banks' domestic balance sheets to expand is likely to be more limited than in the years preceding the crisis, given the more cautious approach of the household and business sectors towards leverage. Banks and their shareholders may therefore need to adjust their return expectations to be consistent with an environment of slower credit growth.

Despite the relatively favourable macroeconomic environment and low level of unemployment, the ratio of Australian banks' non-performing assets to total assets remains close to its recent peak, though it is well below the levels seen in the early 1990s and those currently experienced in many other developed countries. Business loans still account for the bulk of banks' non-performing loans, but there has been some reduction in these recently. In contrast, the non-performing share of banks' housing loans has drifted higher since late 2010. The bulk of non-performing housing loans are well collateralised and therefore not likely to lead to material losses.

The insurance industry in Australia has coped well with the elevated levels of claims from the natural disasters at the start of 2011, assisted by robust reinsurance arrangements. Profits of these firms declined in the March quarter, but have since recovered. However, their costs of reinsurance have risen, and at least some of the increase is already being passed on to customers.

The household sector in Australia is continuing to exhibit a more cautious approach to its spending and borrowing behaviour than prior to the crisis. The household saving rate increased further over the past year and debt has continued to grow at a rate broadly in line with income growth. This relative caution may partly be motivated by recent volatility in households' net asset position following a long period of rapid expansion. Around half of mortgage borrowers are continuing to make substantial excess principal repayments, which is improving their resilience to any change in financial conditions. Even so, household indebtedness remains quite high, as does the aggregate debt-servicing ratio, though both are below their recent peaks. While the mortgage arrears rate drifted up over the first half of the year, it nonetheless remains at a low level by international standards and in absolute terms. The rise has mainly related to loans taken out prior to 2009, when banks' lending standards were weaker; newer loans are performing well despite the increase in interest rates over the past couple of years.

The business sector is also experiencing mixed conditions: mining and related sectors continue to benefit from the resources boom, while other sectors, including retail, are facing pressures from subdued domestic household spending and the high exchange rate. Sectoral measures of profits and business confidence have therefore diverged. Having deleveraged considerably, the business sector is in a stronger financial position overall than it was several years ago. Businesses' demand for external funding remains weak. This is partly because the business sector has been able to finance a larger share of its investment through internal funding in recent years, as much of that investment has been concentrated in sectors such as mining, where profitability has increased the most.

Regarding financial regulatory issues, national authorities are in the process of deciding how best to implement the Basel III bank capital and liquidity reforms. The Australian Prudential Regulation Authority (APRA) recently published a consultative document on how it intends to implement the Basel III capital reforms in Australia. Given that the Australian banking sector has already substantially bolstered its capital position in recent years, it is well placed to meet the new standards. APRA has therefore proposed a faster timetable for adoption

of the new global minimum capital standards than required under the Basel III rules.

Meanwhile, the international regulatory reform agenda has recently been focused on developing a policy framework to address the risks posed by systemically important financial institutions (SIFIs). Agreement is close to being finalised on a methodology to identify banks that are systemically important in a global context, along with the level and form of additional capital that these institutions will be required to hold above the Basel III requirements. Another aspect of this work has been the development of a set of principles on effective resolution regimes for SIFIs, which are intended to enhance authorities' ability to resolve distressed SIFIs without disrupting the wider financial system or exposing taxpayers to losses. There has also been progress over the past six months on a number of other international regulatory initiatives, including the move towards central clearing of over-the-counter derivatives and developing policy frameworks to address the risks posed by shadow banks. Australia continues to be an active participant in the various international discussions that are shaping these reforms.

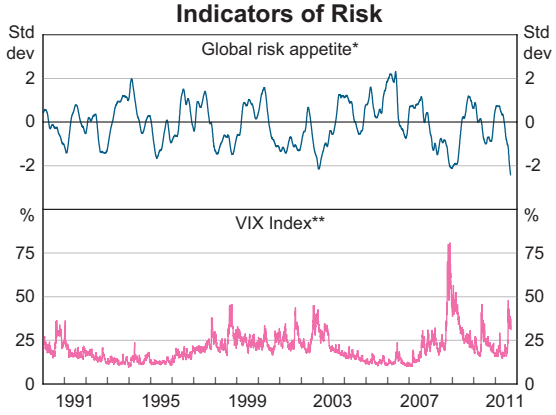
Domestically, the Australian Government recently introduced legislation into Parliament that would permit deposit-taking institutions to issue covered bonds. It has also announced the permanent arrangements to be put in place for the Financial Claims Scheme, following a review by the Council of Financial Regulators (CFR) of how the Scheme should be configured in a post-crisis environment. More recently, the CFR has been examining a number of issues related to the regulation and crisis management arrangements for financial market infrastructures in Australia.

1. The Global Financial Environment

Public finances have deteriorated substantially in a number of advanced economies since the onset of the financial crisis, particularly in Europe, leading to growing market concerns about the sustainability of sovereign debt. Difficulties were initially centred on Greece, Ireland and Portugal, which all received international bailout packages during the past year and a half. But more recently, sovereign debt concerns have spread to a wider range of countries in Europe, including the much larger economies of Italy and Spain. Severe market reactions to sovereign credit risk have resulted in funding difficulties for banks in some of these countries and tensions in broader euro area bank funding markets. Although they are not as pressing as the problems in Europe, there have also been concerns about unsustainable public debt dynamics in the United States and Japan.

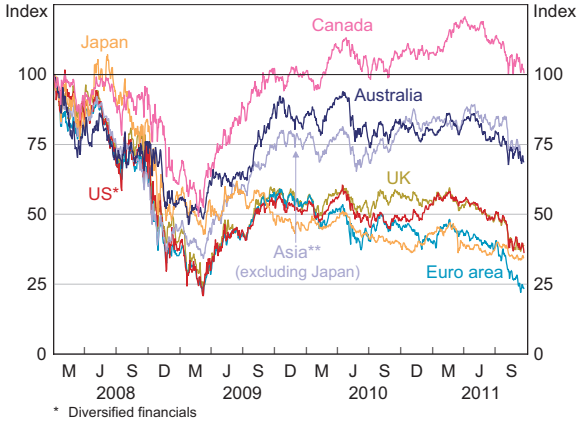
Risk aversion and volatility in global financial markets have increased sharply since the start of August (Graph 1.1). This was triggered by a combination of factors, including: growing concerns about the creditworthiness of some large sovereigns in Europe; concerns about the passage of the US debt-ceiling increase, followed by Standard & Poor's (S&P) downgrade of the US credit rating; a weaker economic outlook in the United States and Europe; and related fears about the effect on financial systems. Underlying all this, markets seem to have become increasingly pessimistic about the ability of policymakers to resolve the situation, given the apparent lack of political support within and across some countries, and the limited policy tools available. Across many countries, prices of shares and other risk assets have declined sharply since early August. Bank and insurer share prices have been particularly affected, falling by more than 15 per cent in most countries, to be around their lowest levels since early 2009 (Graph 1.2). Credit markets have

Graph 1.1
Indicators of Risk



* Credit Suisse Global Risk Appetite Index; 30-day moving average of standard deviations from mean
** Implied volatility from equity options on the S&P 500 Index
Sources: Bloomberg; Credit Suisse; RBA

Graph 1.2
Banks' Share Prices
1 January 2008 = 100



* Diversified financials
** MSCI financials index
Source: Bloomberg

also tightened globally, although conditions are still generally better than they were during the height of the crisis in 2008–09.

This current episode of risk aversion and volatility follows a number of periods of heightened market turbulence over the past couple of years. These periodic events indicate that financial market participants remain sensitive to bad news following the experience of 2008–09. While the latest bout of market uncertainty is not on the scale of 2008–09, it is unclear at this stage whether it will be another temporary episode or whether it is foreshadowing a more serious market dislocation.

Compared to the pre-crisis period, the large banks in the major advanced economies are better placed to withstand a period of renewed market stress. In particular, they have significantly strengthened their capital positions over the past few years and there is now less uncertainty about banks' exposures than there was during the crisis. Funding structures have also generally been improved, although some banks are still relatively reliant on short-term wholesale funding and are therefore susceptible to market strains. Most large banks have continued to post solid profits over recent periods. Even so, a further escalation in sovereign strains within Europe could adversely affect some large banks by increasing their funding costs and causing asset write-downs. Many of these banks are also vulnerable to a slowing in the pace of economic recovery because they still have an elevated level of non-performing loans, particularly property-related loans, and property markets are still weak in many advanced economies.

Banking systems in emerging Asia remain in much better shape than those in the major advanced economies. The profitability of large banks in the Asian region has been strong recently, supported by robust growth in deposits and lending. These banks are relatively well placed to cope with the current market strains: they are largely focused on strongly growing domestic markets and have little direct exposure to euro area sovereigns and banks. However, asset prices and credit have been growing strongly in a few Asian countries, so any unwinding in asset markets there could expose credit quality problems.

Global reinsurers and general insurers have been dealing with a number of large catastrophe events in 2011. While these firms have experienced significantly lower profits as a result, they have maintained high capital buffers.

Sovereign Debt Concerns

Market concerns about the sustainability of some countries' sovereign debt positions in Europe intensified over the past six months. Portugal came under significant funding pressure during March and April, forcing it to request international financial assistance from the European Union (EU) and International Monetary Fund (IMF). A rescue package was announced in early May, making Portugal the third euro area country to receive a bailout after Greece and Ireland in 2010.

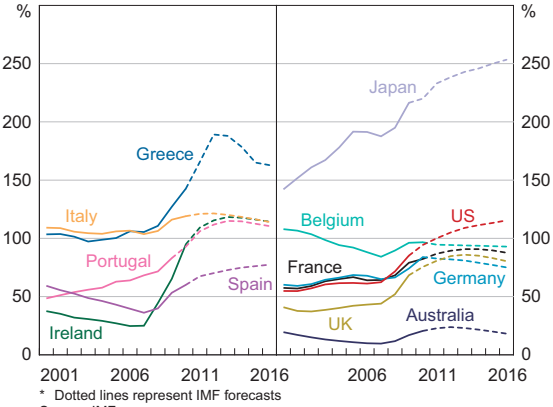
Greece also came under renewed market pressure during the past six months because of difficulties in meeting the terms of its 2010 bailout package. Concerns that it would be unable to re-enter debt markets in 2012 as previously assumed raised the prospect of a further funding shortfall. Protracted negotiations over another assistance package and demands for private-sector burden-sharing caused significant uncertainty in markets around the middle of the year. A second EU/IMF rescue package for Greece was eventually announced in July. It aims to improve Greece's long-term debt position by extending the maturities and reducing the interest rates on its new EU loans (these more generous loan terms will also be applied to Ireland and Portugal), and by providing funding to buy back debt from private investors. The revised program also envisages that part of the funding shortfall will be met from private investors rolling over debt and exchanging existing bonds for new bonds with longer maturities, with these measures expected to result in private investor losses on Greek sovereign debt of about 20 per cent on average. In addition, Greece agreed to implement tougher fiscal tightening measures and sell some state assets. Even with these measures,

the IMF is forecasting Greece's public debt-to-GDP ratio to continue to rise sharply in 2012 due to further fiscal deficits and weak economic conditions (Graph 1.3).

While the second assistance package for Greece is yet to be fully approved, deteriorating economic conditions mean the country has been struggling to meet the terms of its original bailout package. This has contributed to uncertainty about whether further tranches of financial assistance under the first package will be provided by the EU and IMF, which has been weighing on market sentiment in recent weeks. Associated with this, there has been increasing market speculation that Greece may default, and spreads on Greek government debt have risen sharply as a result (Graph 1.4). By contrast, market sentiment towards Ireland has improved over recent months, with 10-year Irish government bond yields declining by about 5½ percentage points since mid July. Underlying this, market participants seem increasingly confident that Ireland will meet the fiscal and banking reform targets set out in its international assistance package.

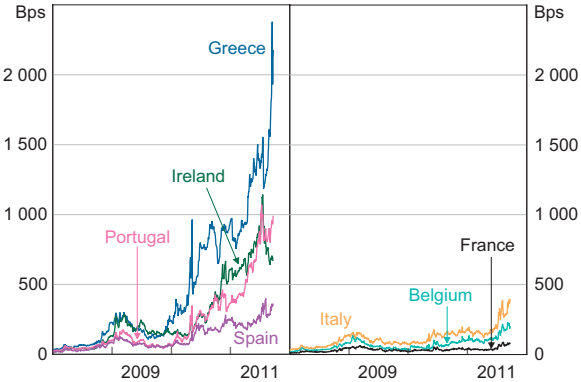
More generally, to help support financial stability in the region, EU authorities have in recent months announced plans to expand the role of the European Financial Stability Facility (EFSF), and its replacement from mid 2013, the European Stability Mechanism (ESM), including by allowing them to purchase sovereign debt on secondary markets and finance bank recapitalisations. The effective lending capacity of the EFSF was also increased to €440 billion (about €50 billion is already allocated), or €500 billion in the case of the ESM. However, some market commentators continue to doubt whether these facilities would be sufficient to resolve funding difficulties for some large euro area sovereigns with high debt if they were to get into trouble. Indeed, concerns about sovereign debt sustainability in Italy and Spain escalated in July. Government bond yields in these countries rose briefly to their highest levels since at least the introduction of the euro in 1999. S&P downgraded Italy's credit rating from A+ to A

Graph 1.3
General Government Gross Debt*
Per cent of GDP



* Dotted lines represent IMF forecasts
Source: IMF

Graph 1.4
European Government Bond Spreads
To 10-year German Bunds



Source: Bloomberg

(with a negative outlook) in mid September, in part due to weaker economic growth prospects.

With the changes to the EFSF yet to be approved by national parliaments, the European Central Bank (ECB) resumed purchases of euro area government debt in secondary markets in August under its Securities Markets Program. Around €150 billion of sovereign debt has been purchased since the inception of this program, with recent purchases of about €80 billion believed to comprise mostly Italian and Spanish sovereign bonds. The yields on these countries' long-term bonds initially fell noticeably, but have subsequently risen again in association with

fears over softening regional economic conditions and delays in the establishment of the second Greek rescue package.

Although not as pressing as the situation in the euro area, there have also been concerns about government debt sustainability in the United States and Japan. Government debt-to-GDP ratios are high in both of these countries, especially so in the case of Japan, and are projected by the IMF to continue to rise over the next four years at least (Graph 1.3). S&P downgraded the US credit rating from AAA to AA+ (with a negative outlook) in August based on its view that the US political system may be unable to reach agreement on the fiscal consolidation measures required to restore the United States to a sustainable fiscal path. S&P subsequently downgraded the credit ratings of a number of US agencies, banks and clearinghouses whose status is dependent on that of the sovereign. This contributed to the increased market turbulence in August. Japan's sovereign credit rating was also downgraded in August; Moody's reduced the rating one notch to the equivalent of AA-, bringing it into line with S&P's rating, which had been downgraded earlier in the year. Despite rating changes, long-term government bond yields in the United States and Japan have fallen since the start of August as risk aversion has grown.

The severe market reactions to the deteriorating sovereign debt positions have left governments with a difficult balancing act: credible fiscal consolidation plans are required to allay concerns about debt sustainability, yet tightening budget positions too much and too early may undermine economic recovery and thus fiscal positions. A further complication is that there is less scope for monetary policy in the affected countries to counterbalance any fiscal consolidation. The governments of a number of European countries have recently introduced some further short- and medium-term fiscal consolidation measures, but market participants are pressuring some of them to strengthen these plans.

The Impact of Sovereign Credit Risk on Bank Funding

An increase in sovereign credit risk can adversely affect banks' balance sheets and funding in several ways. It can induce losses on banks' direct holdings of government debt; reduce the value of the collateral banks use to raise funding; and reduce the funding benefit banks receive from implicit and explicit government support.[1] Accordingly, sovereign credit rating downgrades often lead to downgrades of those countries' domestic banks. Moreover, sovereign risk in one country can spill over to banks in other countries through a number of channels, including through banks' holdings of foreign sovereign debt, cross-border exposures to other banks and claims on non-financial entities in affected foreign countries. These kinds of inter-linkages have been particularly important within the euro area in recent months.

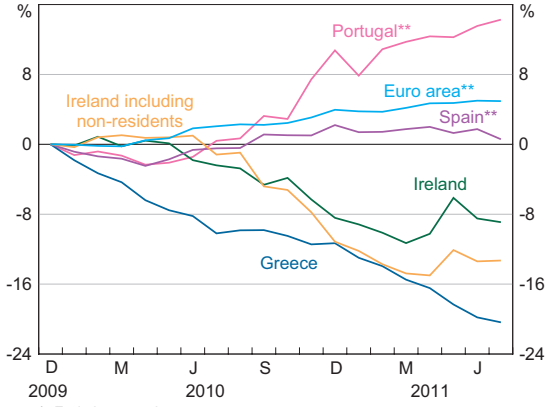
Concerns about sovereign risk in Greece, Ireland and Portugal have been contributing to difficult funding conditions for banks in these countries for some time, compounding the problems they were already facing from weak domestic economic conditions and property prices. As these countries' sovereign credit ratings have been progressively downgraded, many of their banks have also had their ratings downgraded (generally to below investment grade). Funding spreads for these banks have widened sharply, making it difficult for them to raise wholesale debt, and forcing them to rely more on central bank funding or other forms of official support. As at end July, central bank lending was equivalent to about 20 to 25 per cent of Greek and Irish banks' assets and around 8 per cent of Portuguese banks' assets.

Despite stronger competition for deposits, banks in some of these countries have also experienced substantial deposit outflows. Greek banks' domestic private sector deposits have declined by about one-fifth since the end of 2009, with reports that

1 Committee on the Global Financial System (2011), 'The Impact of Sovereign Credit Risk on Bank Funding Conditions', CGFS Papers, No 43, July.

depositors have been shifting money to other countries on concerns about possible devaluation in the event that Greece abandons the euro (Graph 1.5). Irish banks have also experienced significant deposit outflows, especially of non-residents' deposits, which have declined by more than 25 per cent since mid 2010, compared with a 7 per cent fall in residents' deposits. By contrast, deposits in Portuguese and Spanish banks have generally held up over the past year.

Graph 1.5
Banks' Domestic Private Sector Deposits*
Cumulative percentage change from end December 2009

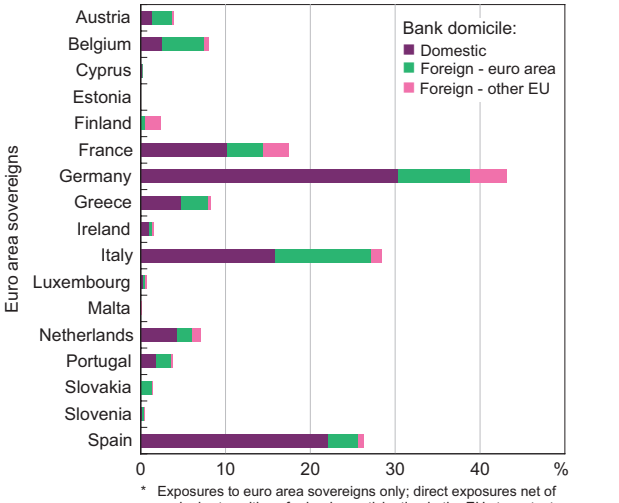


* Excludes repurchase agreements
** Includes deposits at non-bank financial institutions, and for the euro area, non-central government deposits
Sources: ECB; central banks

Italian banks, which have significant exposures to the Italian sovereign, have also come under greater funding pressure in recent months as sovereign debt concerns have spread to Italy. Their borrowing from the ECB has increased substantially since June, from €40 billion to €85 billion, equivalent to about 2 per cent of their assets. Spanish banks have also increased their borrowing from the ECB over the past couple of months. Compared with Greece, Ireland and Portugal, increases in sovereign risk in Italy and Spain have the potential for much larger regional repercussions given the greater amount of their debt on issue and its wider distribution within the euro area. Excluding domestic banks, net exposures of European banks to Italian sovereign debt are equivalent to around 13 per cent of these banks' aggregate core Tier 1 capital, compared with 4 per cent for Spanish sovereign debt, and 6 per cent for Greek, Irish and Portuguese sovereign debt combined (Graph 1.6).

As sovereign risk has spread to a broader range of countries, investors have become increasingly concerned about the exposures of some of the larger European banking systems to banks and sovereigns of the affected countries (Table 1.1). Many large European banks are also exposed through their direct lending to households and businesses in these countries, the performance of which would be expected to deteriorate if sovereign or banking strains exacerbated the weakness in local economic conditions. Reflecting these significant cross-border exposures, CDS premia for banks in France and Germany have recently widened and their share prices have fallen sharply (Graph 1.7). Moody's downgraded the credit rating of a large French bank in mid September because of its significant exposure to Greece.

Graph 1.6
EU Banks' Sovereign Exposures*
Per cent of aggregate core Tier 1 capital, as at end December 2010



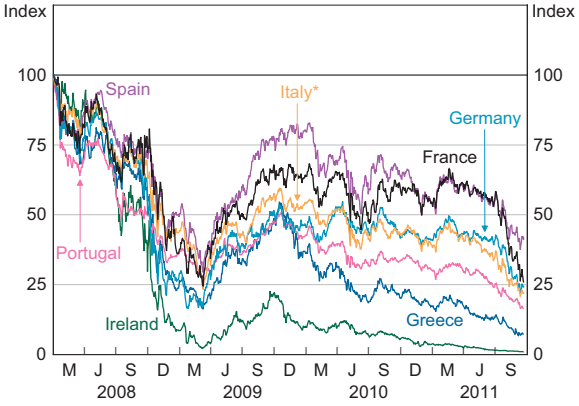
* Exposures to euro area sovereigns only; direct exposures net of cash short positions for banks participating in the EU stress test, which represent about 65 per cent of EU banking system assets
Source: EBA

Table 1.1: Foreign Bank Claims on Euro Area Countries[a]
Ultimate risk basis, as at 31 March 2011, per cent of lending country's total bank assets[b]

Reporting banks (by headquarter location)	Greece	Ireland	Italy	Portugal	Spain	Subtotal	Total euro area
Euro area banks	0.2	0.5	1.6	0.4	1.1	3.9	10.5
of which:							
Belgian	*0.1*	*1.7*	*1.6*	*0.2*	*1.4*	*5.1*	*12.9*
Dutch	*0.2*	*0.6*	*1.5*	*0.2*	*2.4*	*4.9*	*18.2*
French	*0.5*	*0.3*	*3.8*	*0.3*	*1.3*	*6.2*	*13.2*
German	*0.2*	*1.0*	*1.5*	*0.3*	*1.6*	*4.6*	*10.9*
Italian	*0.1*	*0.3*	*–*	*0.1*	*0.6*	*1.0*	*10.6*
Portuguese	*1.3*	*0.7*	*0.4*	*–*	*3.5*	*5.9*	*9.5*
Spanish	*0.0*	*0.2*	*0.7*	*1.8*	*–*	*2.8*	*5.4*
Swiss banks	0.1	0.5	0.7	0.1	0.8	2.2	12.6
UK banks	0.1	1.2	0.6	0.2	0.9	3.1	9.3
US banks	0.1	0.3	0.3	0.0	0.3	1.0	5.1
Japanese banks	0.0	0.2	0.4	0.0	0.2	0.9	4.4
Australian banks	–	0.2	0.1	–	0.1	0.3	1.8

(a) Based on 24 countries reporting to the BIS
(b) Monetary financial institutions' assets used as a proxy for total bank assets for countries in the euro area and the United Kingdom
Sources: BIS; RBA; Thomson Reuters; central banks

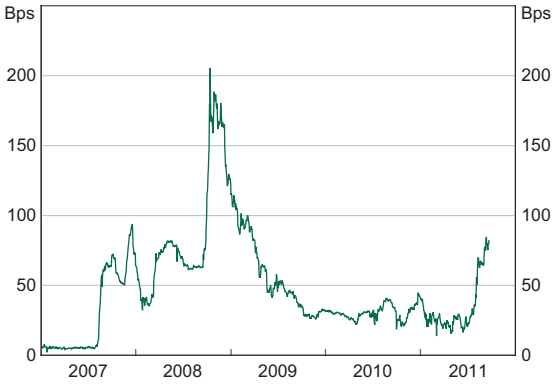
Graph 1.7
Euro Area Banks' Share Prices
1 January 2008 = 100



* MSCI diversified financials
Source: Bloomberg

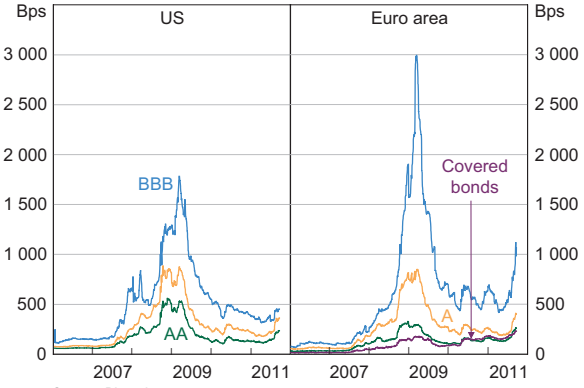
Concerns about banks' exposures within the euro area have contributed to a tightening of credit markets in recent months, although conditions remain better than in 2008–09. In money markets, the spread between 3-month interbank lending rates (Euribor) and expected overnight rates has risen by more than 45 basis points since the start of August, to the highest level since early 2009 (Graph 1.8). US dollar funding pressures have also emerged as access to US commercial paper and deposit markets have been curtailed. US money market funds, which are significant providers of short-term US dollar funding to European banks, have experienced sizeable investor outflows in recent months. While these money market funds had already all but stopped their lending to banks in Greece, Ireland, Italy, Portugal and Spain, they have recently also been reducing and shortening their exposures to banks in other euro area countries. In response, the ECB and four other major central banks recently announced co-ordinated 3-month US dollar liquidity operations on specific dates later this year. These operations are in addition to the seven-day US dollar liquidity facilities already offered by the ECB and the Bank of England.

Graph 1.8
3-month Euribor Spread
To overnight indexed swaps



Source: Bloomberg

Graph 1.9
Banks' Bond Spreads
To equivalent maturity government bonds

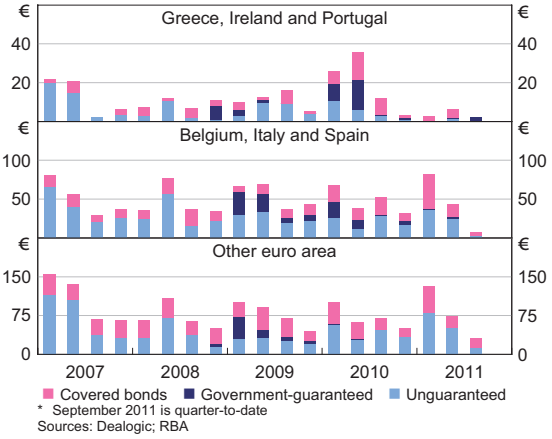


Source: Bloomberg

Spreads on longer-term bank debt in the euro area have now increased to above the levels seen in mid 2010, although for higher-rated unsecured bonds and covered bonds these increases are entirely due to lower benchmark sovereign yields (Graph 1.9). Consistent with this shift in credit market conditions, bond issuance by euro area banks has slowed in recent months (Graph 1.10). However, issuance (other than by Greek, Irish and Portuguese banks) had been strong earlier this year, suggesting that some banks may not need to access term debt markets in the near future. The larger European banks have also bolstered their liquidity positions since the crisis. Even so, many of them are still relatively reliant on wholesale funding, including short-term US dollar funding. There is a risk, therefore, that if the sovereign debt problems in Europe were to deepen or become more protracted, these larger European banks could encounter more severe funding strains, which could then propagate stresses more broadly in the global financial system.

While heightened risk aversion associated with the sovereign debt problems in Europe has resulted in a sharp increase in global market volatility over the past couple of months, bank funding markets outside the euro area have so far been less affected. Short-term interbank spreads have increased by much less in the United States and United Kingdom this year than in the euro area. Bank bond spreads have widened across a number of markets, although the increases for lower-rated issuers have been less than in the euro area. Large banks in the United States and United Kingdom have significantly increased the share of their funding from deposits over the past few years, which should make them more resilient to stresses in wholesale funding markets.

Graph 1.10
Euro Area Banks' Bond Issuance*



* September 2011 is quarter-to-date
Sources: Dealogic; RBA

Bank Capital

Bank capital positions have been strengthened substantially since the 2008 crisis, increasing the resilience of the major banking systems, and in principle helping them to cope with a renewed period of market stress. Progress in improving bank

capital positions has tended to be slower in the euro area than in other regions over the past few years, although recently there has been a more concerted effort to raise additional capital.

Bank supervisors in a number of the troubled euro area countries have recently raised the minimum core Tier 1 capital requirements for their banks, to levels above the future Basel III requirements, and with a shorter timetable for adherence (Table 1.2). This has forced some banks in these countries to raise capital, either privately or from the government, including from funds set aside in international financial assistance programs. The aim of these measures is to shore up market confidence in banks' solvency given the weak domestic economies and their sizeable exposures to domestic sovereign debt.

More generally, the recently completed EU-wide bank stress test has provided some impetus for improving bank capitalisation in the region. The results of the stress test, published by the European Banking Authority (EBA) in July, included detailed information on the capital positions of 90 EU banks (representing about 65 per cent of EU banking system assets). Capital raisings and other measures affecting bank capital positions (such as mandatory restructuring plans) were required to be publicly announced and committed to by end April if they were to be included in capital for the purposes of the test. In aggregate, participating banks undertook €50 billion in approved capital measures in the first four months of 2011, adding 0.4 percentage points to their aggregate end 2010 core Tier 1 capital ratio of 8.9 per cent.

The EU stress test found that the majority of participating banks maintained reasonable capital buffers under a two-year stress scenario for the macroeconomy and financial markets. Eight relatively small banks failed to meet the benchmark 5 per cent core Tier 1 capital ratio under the stress scenario (see 'Box A: European Bank Stress Tests'). Nearly all of these banks were from countries where bank supervisors have already raised the minimum core Tier 1 capital requirement.

Detailed information on participating banks' sovereign and other exposures to individual EU countries were disclosed in conjunction with the EU stress test results. This enhanced transparency should mean there is less uncertainty about EU banks' problem exposures than there was during the 2008 crisis, along with the fact that these exposures are less complex than the structured securities that triggered the crisis. While this transparency should help limit any contagion effects, market participants seem increasingly concerned about the creditworthiness of some EU banks' exposures to euro area countries where the economic outlook has deteriorated noticeably since the EU stress test was conducted. This, in turn, has raised questions

Table 1.2: Core Tier 1 Capital Ratios for Banks in Selected Euro Area Countries

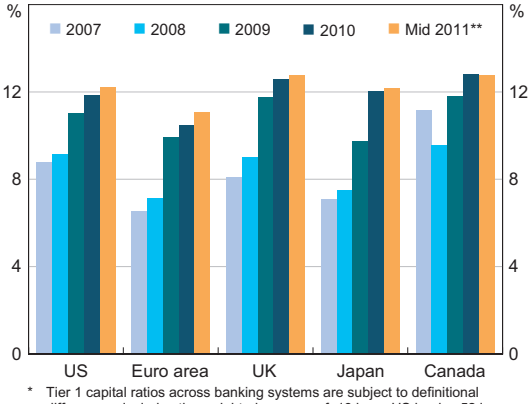
	Minimum requirement	Supervisory deadline
	Per cent of risk-weighted assets	
Cyprus	8	July 2011
Greece	10	January 2012
Ireland	10½	March 2011
Portugal	9 and 10	End 2011 and end 2012
Spain	8 or 10[(a)]	September 2011
Memo items:		
Basel III common equity Tier 1	3½ and 4½	January 2013 and 2015
Basel III common equity Tier 1 plus conservation buffer	7	January 2019

(a) Minimum requirement is 10 per cent for those banks which are not listed or are more reliant on wholesale funding
Sources: BCBS; national authorities

about the adequacy of these banks' capital and funding positions.

Outside the euro area, bank capital positions have been strengthened further in most other major banking systems during the past year. Recent increases in Tier 1 capital ratios for banks in the United States, United Kingdom, Japan and Canada have generally been smaller than in the euro area, but this mainly reflects that these banks bolstered their capital positions to higher levels in 2009 and 2010 (Graph 1.11). Unlike in the euro area, most of these banks have recently been accumulating capital largely through retaining earnings rather than raising new equity. Internal capital generation for the large US and UK banks has been aided by dividend payout ratios that are still below pre-crisis levels. Capital ratios have also been supported by slow growth in risk-weighted assets, in line with subdued credit growth.

Graph 1.11
Large Banks' Tier 1 Capital*
Per cent of risk-weighted assets

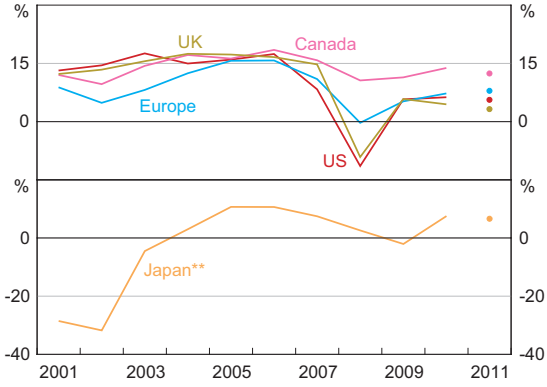


* Tier 1 capital ratios across banking systems are subject to definitional differences; includes the weighted average of: 19 large US banks, 52 large institutions from across the euro area, the five largest UK banks, the three largest Japanese banks and the six largest Canadian banks
** End June for US, euro area, UK and Japan; end July for Canada
Sources: Bloomberg; CEBS; EBA; FDIC; RBA; banks' annual and interim reports

Bank Profitability

The large banks in the major advanced countries generally continued to report profits in the first half of 2011, although results were quite mixed across institutions, and overall profit levels and returns on equity remained subdued compared to the pre-crisis period (Graph 1.12). Whereas declining

Graph 1.12
Large Banks' Return on Equity*
After tax and minority interests

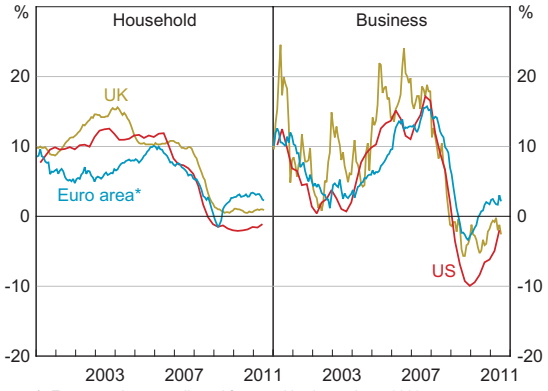


* Return on equity of the six largest US banks, 10 largest listed European banks (including Switzerland), five largest UK banks, four largest Japanese banks and six largest Canadian banks; 2011 profit is annualised and total equity is assumed constant from last reporting date
** 2001–07 results are to fiscal year ended 31 March
Sources: Bloomberg; RBA; banks' annual and interim reports

loan-loss provisions had supported banks' profit growth in 2010, provisions have fallen more modestly or been stable in recent periods. Trading income has tended to be volatile, reflecting shifts in market conditions, but was generally weaker for most large banks in the first half of 2011 than a year earlier. With net interest margins broadly steady, weak credit growth across the major banking systems has meant that growth in net interest income remains subdued.

Ongoing weak credit growth has been associated with continued weakness in property markets and hesitant economic growth in the major economies. The level of household credit (which mainly comprises housing credit) is still falling in the United States, and while household credit growth has recovered over the past year or so in the euro area, recent outcomes have been softer (Graph 1.13). Business credit has been even weaker and is still falling in the United Kingdom and the United States, although the rate of contraction is less than in 2009 and early 2010. Loan officer surveys generally indicate that demand for credit remains subdued. This is particularly the case for households, consistent with weak housing market conditions, high debt burdens and high unemployment.

Graph 1.13
Credit Growth
Six-month-ended annualised, seasonally adjusted



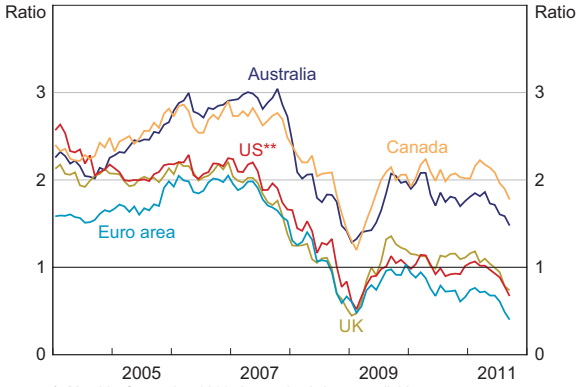
* Euro area data not adjusted for securitisations prior to 2009
Sources: Bank of England; ECB; RBA; Thomson Reuters

Aggregate profits of the six largest banking groups in the United States (representing around one-half of US banking system assets) were held down in the first half of 2011 by a large second-quarter loss at Bank of America. Bank of America's loss was mainly due to expenses related to buybacks of poorly underwritten mortgages and related legal costs. Profits of the remaining five large US banks were around 8 per cent higher than the year before, supported by further modest declines in loan-loss provisions. Some US banks are still facing the prospect of further large expenses related to the resolution of previous poor mortgage practices. Across all US Federal Deposit Insurance Corporation (FDIC) insured institutions, profits in the first half of 2011 were much higher than a year earlier, with results for smaller institutions improving noticeably.

In Europe, aggregate profits of the 10 largest banking groups (including two Swiss banks) were around 7 per cent lower over the year to the first half of 2011, in part reflecting difficult trading conditions for some banks related to the sovereign debt problems in Europe. Some large euro area and UK banks have also had to set aside significant provisions for expected losses on Greek sovereign debt held in their banking books. More recently, the Swiss bank UBS revealed estimated losses of around US$2.3 billion incurred following unauthorised trading; these losses will affect its profits for the second half of 2011. Profits of the large UK banks were mixed in the first half of 2011: those with significant exposures to emerging markets recorded growth in profits, while others continued to record losses, mainly due to substantial compensation payments to customers who were previously mis-sold loan payment protection insurance. For the large Japanese banks, profits in the first half of 2011 were about 4 per cent lower than a year earlier, although they were little affected by the earthquake and tsunami in March. The largest Canadian banks generally continued to post solid results in the latest half year, although one bank recorded a large fall in profits due to a loss on the sale of its US banking business.

The difficult macro-financial environment in the major economies continues to cloud the outlook for bank profitability. In the near term, the renewed market turmoil may result in some losses in banks' trading books and may adversely affect their investment banking revenues. Profits would be more severely affected if the sovereign debt problems in Europe were to escalate further, resulting in higher funding costs and more asset write-downs. Investors appear to be pessimistic about banks' future profitability, with the market valuation of many large banks in the euro area, the United Kingdom and the United States falling below the book valuation reported in their financial statements (Graph 1.14).

Graph 1.14
Banks' Price-to-book-value Ratios*

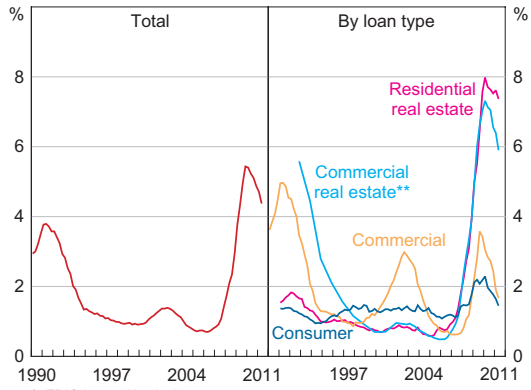


* Monthly; September 2011 observation is latest available
** Diversified financials
Source: Bloomberg

Property-related exposures remain another key vulnerability for banks in the major advanced countries. In the United States, non-performing loan ratios for both commercial and residential property remain around their historical highs, despite small declines since early 2010 (Graph 1.15). Troubled property exposures, particularly commercial real estate loans, continue to contribute to failures among smaller banks in the United States. Over the year to date, there have been 71 failures of FDIC-insured institutions in the United States; although this number represents only about 1 per cent of all US FDIC-insured institutions, more than 10 per cent of institutions are still considered vulnerable by the FDIC, a slightly larger proportion than the 1990 peak. In Europe, non-performing loans have continued to increase for many banks that have significant exposures to depressed property development markets. The available nationwide data indicate that bank non-performing loan ratios have increased further in Ireland and Spain over the past year.

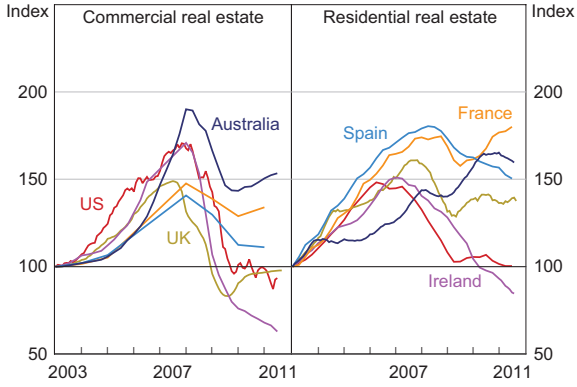
Improved performance of these exposures would require a durable recovery in economic and property market conditions. Many commercial and residential property exposures are likely to be in negative equity, as property prices remain well below their peaks in most countries (Graph 1.16). Commercial and residential property prices continued to fall in the United States over the past year, as well as in a number of European countries, including Ireland and Spain – two countries that have experienced particularly large booms and busts in property development. Authorities in some jurisdictions have been concerned about forbearance of property (and other) loans by banks, such as by extending loan maturities or converting loans to interest-only terms. These actions help borrowers cope with temporary periods of financial distress and avoid the need for banks to sell assets into already depressed markets. However, they could leave banks under-provisioned if economic and financial conditions turn out weaker than expected. The slowing in economic activity in some of these countries since mid year suggests an increasing likelihood that this risk will be realised.

Graph 1.15
US Non-performing Loans*
Per cent of loans



* FDIC-insured institutions
** Includes construction and development loans
Source: FDIC

Graph 1.16
Property Price Indicators
31 December 2002 = 100



Sources: Bloomberg; Jones Lang LaSalle; Property Council of Australia; RBA; RP Data-Rismark; Thomson Reuters

Over the longer term, it is likely that banks and the investor community will need to lower their return expectations. Many banks need to continue to increase their common equity positions to meet the Basel III requirements, and in some cases, the extra capital buffers that the Financial Stability Board and Basel Committee on Banking Supervision have proposed to apply to global systemically important banks (see the 'Developments in the Financial

System Architecture' chapter). While this should make them more resilient, it means their returns over the medium term are likely to be lower than before the crisis. Capital positions will need to be built up partly via banks preserving a higher share of internally generated revenue than in the pre-crisis period – for example, by lowering dividend payout ratios or reducing the share of revenue paid to employees. But the task of revenue generation will also be challenged by a regulatory and supervisory framework that will, appropriately, limit bank risk-taking compared to the recent past. Although some large banks have lowered their target returns below the rates seen in the few years before the crisis, in many cases these targets remain high when compared with returns achieved over a longer period. If banks and their investors continue to target unrealistic returns, then they may take on risks that could ultimately sow the seeds for future financial distress.

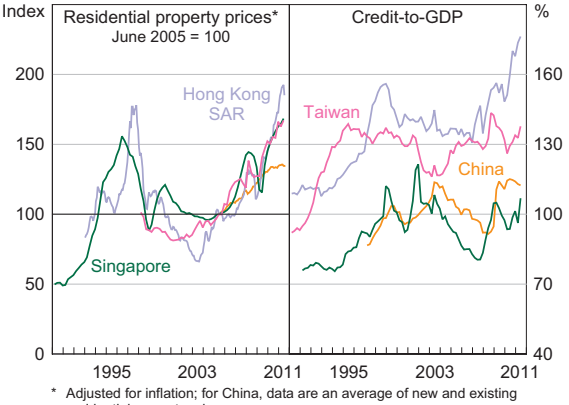
Banking Systems in Emerging Asia

Banking systems in the emerging Asian region remain in much better shape than many of those in the major advanced economies. While Asian banks were not completely immune from the global financial and economic strains during the crisis, their focus on strongly growing domestic banking markets and their relatively low reliance on offshore wholesale funding sources partly insulated them. They largely avoided building up portfolios of the types of structured securities that banks in the North Atlantic region have had to write down. As such, with a few exceptions, banks in the Asian region did not require public sector capital support. Given their domestic focus, Asian banks are well placed to cope with the current market stresses stemming from the sovereign debt problems in Europe, because they have little direct exposures to euro area sovereigns or banks. However, spillovers to Asian economies and their banking systems may occur if some large European banks are forced to reduce their exposures in Asia.

The profitability of the large Asian banks has generally remained strong in 2010 and early 2011, with after-tax returns on equity ranging from about 10 to 25 per cent, around the rates seen in the years leading up to the financial crisis. This compares with lower post-crisis average returns of around 5 to 10 per cent for large banks in the United States, United Kingdom, and the euro area. Asian banks' profitability has been supported by robust growth in deposits and lending amid strong economic conditions and high domestic saving rates.

Real interest rates in some fast-growing Asian economies have remained low or negative for some time, despite gradual policy tightening. Credit has therefore expanded at a strong pace over recent years, contributing to significant rises in asset prices in a few countries. Residential property prices in Hong Kong, Taiwan, Singapore and some large cities in China have increased considerably (Graph 1.17). If property prices were to unwind, credit quality could decline. Banks' exposures to property development companies would be most problematic in such a scenario: lending standards for residential mortgages tend to be relatively conservative and have been tightened by supervisors in some countries in recent years. Regulatory impositions for mortgages have

Graph 1.17
Asset Prices and Credit



* Adjusted for inflation; for China, data are an average of new and existing residential property prices

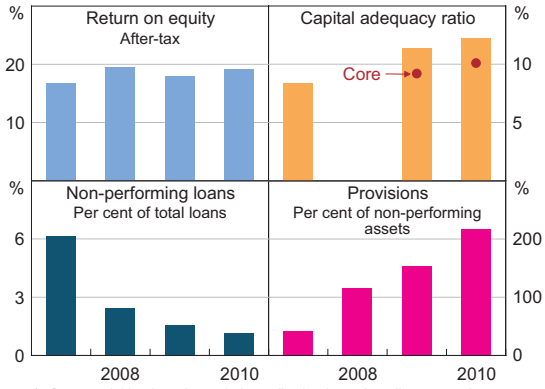
Sources: CEIC; Central Bank of Taiwan; Hong Kong Monetary Authority; Monetary Authority of Singapore; RBA

included increases in minimum down-payment requirements, and introducing or increasing taxes on certain property sales.

The Chinese authorities, in particular, have sought to tighten credit conditions over the past year or so. They have raised banks' required reserves and imposed strict controls over lending, including restrictions on lending for mortgages and to local government entities. It is thought that some of the lending to local governments over recent years was directed to projects that are not commercially viable, which raises asset quality concerns. According to recent estimates by the Chinese national auditors, bank loans to local governments as at the end of 2010 were equivalent to around 20 per cent of GDP, or 10 per cent of banking system assets. Despite these policy actions, however, various forms of off-balance sheet lending (such as bank-accepted bills) have continued to grow strongly. Including off-balance sheet credit, the overall credit-to-GDP ratio in China had increased to about 130 per cent by mid 2011 – a high ratio relative to countries at the same per capita income level.

At this stage, Chinese banks' loan portfolios have not deteriorated: the non-performing loan ratio for all commercial banks fell over 2010, to 1.1 per cent, its lowest level since at least prior to the Asian financial crisis in the late 1990s (Graph 1.18). More recent data indicate that the non-performing loan ratios of the five largest banks (which represent around one-half of Chinese banking sector assets) declined further over the first half of 2011. The Chinese supervisory authority has required banks to increase their provisions and capital buffers over recent years, measures which should help banks deal with any future increase in problem loans. Chinese banks' aggregate core Tier 1 capital ratio was 10 per cent at end 2010 – a higher ratio than in many advanced economy banking systems, but low relative to other Asian banking systems that are also experiencing strong credit growth.

Graph 1.18
Chinese Banks' Financial Position*



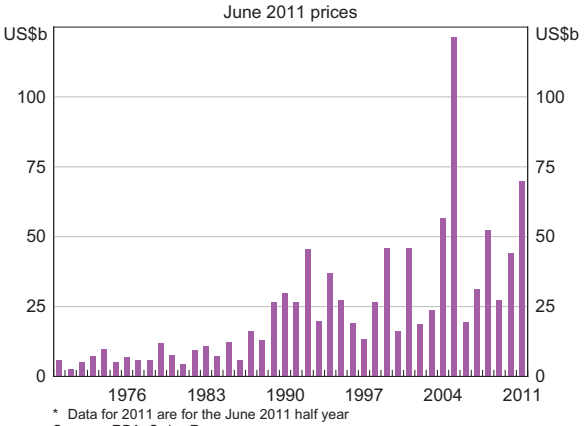
* Commercial banks only; excludes policy banks and credit co-operatives
Source: CBRC

Recent Catastrophe Losses of Insurers

The global insurance industry has been challenged by a spate of natural disasters in 2011. Insured losses from catastrophes in the first half of 2011 are estimated to be around US$70 billion, more than double that in the first half of 2010 and around five times higher than the six-monthly average of the previous decade (Graph 1.19). The high losses are largely due to the earthquake and tsunami in Japan: insured losses from this event are estimated to be around US$30 billion, which would make it the costliest natural disaster for insurers after Hurricane Katrina in the United States in 2005. Insured losses from the February Christchurch earthquake, and the floods and Cyclone Yasi in Queensland, are estimated to be around US$10 billion and US$3½ billion, respectively.

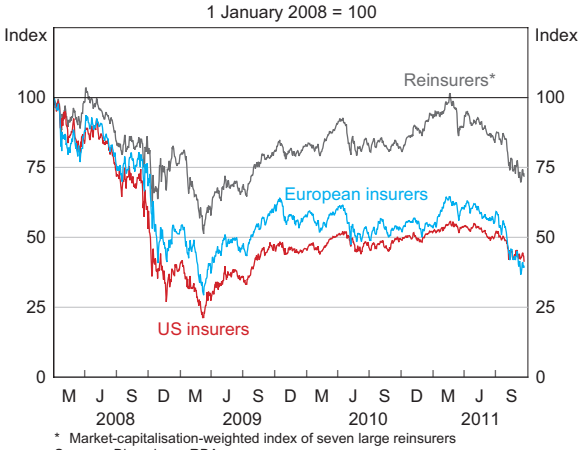
Claims from the recent natural disasters have adversely affected the profitability of large global reinsurers, which reported a small aggregate net loss in the first half of 2011, equivalent to an annualised after-tax return on equity of about –½ per cent (see 'Box B: The Global Reinsurance Industry'). These reinsurers were able to easily absorb these small losses and maintain high capital buffers. The largest global general insurers – AIG, Allianz and Zurich Financial

Graph 1.19
Global Catastrophe Insurance Claims*



* Data for 2011 are for the June 2011 half year
Sources: RBA; Swiss Re

Graph 1.20
Insurers' Share Prices



* Market-capitalisation-weighted index of seven large reinsurers
Sources: Bloomberg; RBA

Services – also reported elevated catastrophe losses in the first half of 2011, though they all remained profitable because of favourable results for their non-catastrophe insurance operations. A couple of the large European insurers and reinsurers have also recorded sizeable impairments on their exposures to Greek debt in the most recent period.

Globally, share prices of insurance and reinsurance firms have fallen more sharply than the broader market since the start of August (Graph 1.20). This likely reflects their sizeable sovereign exposures and, more generally, market concerns about the adverse impact of renewed debt and equity market volatility on insurers' investment portfolios, rather than their insurance operations. If this volatility were to continue, investment losses could reduce insurers' profits. An additional risk to their future profits would emerge if the current US hurricane season were particularly severe, as this would generate further significant catastrophe losses and may place pressure on some insurers' capital reserves. Insured losses from Hurricane Irene in the United States in late August are not expected to be as high as those from major catastrophe events earlier in 2011, with initial estimates around US$2–7 billion.

Box A
European Bank Stress Tests

Stress tests are a common risk management tool used by financial institutions. Prudential supervisors also use stress tests to assess vulnerabilities facing individual financial institutions and financial systems as a whole. These tests typically involve specifying a scenario in which economic and financial variables shift adversely, and then estimating the impact on financial institutions' asset portfolios and capital, as well as other key metrics. The results allow supervisors to identify potential weaknesses and risks in financial institutions, which can then prompt corrective actions.[1] The global financial crisis has significantly increased the focus on stress testing given the strained conditions in many advanced country banking systems.

Like most prudential supervisory activity, the results of stress tests for individual financial institutions are usually kept confidential. This allows supervisors to probe vulnerabilities among financial institutions using more severe scenarios without creating unnecessary public concern about unlikely events. Since the beginning of the financial crisis, however, supervisors in some jurisdictions have chosen to publish the results for individual institutions from industry-wide stress tests – for example, US supervisors released stress test results for 19 large US banking groups in May 2009. Publication has been aimed at reducing uncertainty about the soundness of individual banks, and thus improving market confidence in the broader banking system. It can also be designed to provide authorities with the legitimacy to address weak institutions. In these cases, the stressed or adverse scenario is generally constructed to be less unlikely than in unpublished tests, and the baseline scenario often already involves some degree of stress.

The large banks in the European Union (EU) were subjected to a stress test in 2010, and again earlier this year, and the individual results of both were published. The 2010 stress test was co-ordinated by the Committee of European Banking Supervisors (CEBS), an advisory body comprising representatives from the various national supervisory agencies. The publication of the results from this stress test in July 2010 initially helped to calm market sentiment about the health of European banking systems and their resilience to sovereign debt problems, which had intensified earlier that year. But a few aspects of the methodology for the 2010 stress test were criticised by some commentators. First, a sovereign default was not incorporated in the scenario despite growing market concerns at the time about sovereign debt sustainability for a few euro area countries. While sovereign debt exposures in the participating banks' trading books were required to be marked down, the much larger sovereign exposures in their banking books were not stressed. Second, the capital benchmark chosen – a 6 per cent Tier 1 capital ratio – was inconsistently defined by national supervisors and deemed too easy to pass. Indeed, two Irish banks that met the capital benchmark under the adverse scenario were later found to require significant additional capital, the majority of which has since been provided by the Irish Government.

To alleviate continuing market concerns about the health of European banking systems, a second EU-wide bank stress test was conducted earlier this year by the European Banking Authority (EBA), the

1 A discussion of the different types of stress testing used by financial institutions and supervisors can be found in APRA (2010), 'Stress-testing for authorised deposit-taking institutions', *APRA Insight*, Issue 2, pp 2–12.

successor to the CEBS. The 2011 stress test was applied to 91 institutions, representing about 65 per cent of EU banking sector assets and a minimum of 50 per cent of bank assets in each of the 21 participating countries.[2] The Spanish central bank, which is also the bank supervisor, took the approach of requiring almost all of its domestic banks to participate in the test.

The stress test required banks to estimate their credit impairments, trading losses and capital position, under both a baseline and an adverse scenario for 2011 and 2012. A number of aspects of this stress test were toughened compared with the previous test.

- The adverse economic scenarios were more severe relative to the baseline scenarios and more differentiated across countries. For example, annual EU GDP growth under the adverse scenario was 4 percentage points below the baseline in the 2011 test, compared with 3 percentage points below for the 2010 test.
- Banks were this time required to provision for losses on their banking book sovereign exposures based on assumed credit rating downgrades for sovereigns rated below AAA as at 1 June 2011 (two notches for sovereigns rated AA to A- and four notches for sovereigns rated BBB+ or below). Sovereign exposures were also assumed to have a 40 per cent loss given default.
- A funding cost shock was introduced. Banks' funding costs were increased in line with assumed sovereign spreads (to the German sovereign). It was assumed that at least one-half of the increase in funding costs could not be recovered from customers and therefore flowed directly through to profits and capital.
- A 5 per cent core Tier 1 ratio was consistently adopted as the capital benchmark. This is a stricter definition of capital than the 2010 Tier 1 definition because it excludes capital with lower loss absorbency, including most hybrid instruments.

2 Includes one bank from Norway, which is not part of the EU.

The stress test found that, under the adverse scenario, the aggregate core Tier 1 capital ratio of the participating banks would fall to 7.7 per cent at the end of 2012, down from 8.9 per cent at the end of 2010; it would reach 9.8 per cent under the baseline scenario. Most banks were found to exceed the capital benchmark under the adverse scenario, although the results were quite dispersed (Graph A1). Eight relatively small banks (five from Spain, two from Greece and one from Austria) failed to meet the benchmark 5 per cent core Tier 1 capital ratio.[3] The EBA recommended that national supervisory authorities require these banks to present plans for remedial actions within three months and take action on these plans by end 2011. The relevant national supervisory authorities stated publicly at the time that these banks would have passed the stress test if capital measures announced or planned after the EBA's end-April deadline were included and capital measures not recognised by the EBA (such as general provisions) had been eligible.

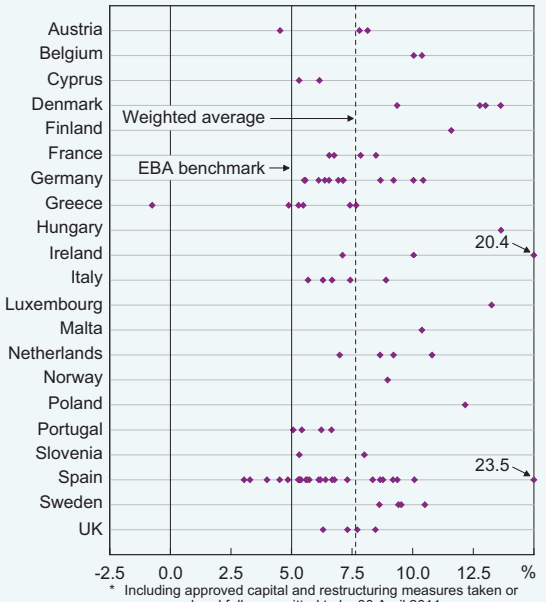
A further 16 banks were estimated to have core Tier 1 capital ratios of between 5 and 6 per cent under the adverse scenario. The EBA recommended that supervisors request banks that had ratios above but close to 5 per cent take steps to strengthen their capital positions if they have sizeable exposures to the sovereigns under most stress.

The decline in banks' core Tier 1 capital ratios under the adverse scenario largely reflected estimated losses on their credit exposures. Credit impairments reduced the aggregate core Tier 1 capital ratio of the participating banks by 3.7 percentage points, compared with a 0.5 percentage point reduction from trading book losses and a 1.1 percentage point decline due to higher risk-weighted assets. These effects were partly offset by increases in

3 One German landesbank that would have also failed the stress test pulled out of the test late in the process after deals to convert local government silent participations – a form of hybrid capital – into approved core capital were deemed ineligible by the EBA. The results presented here therefore cover only 90 banks.

Graph A1
Banks' Core Tier 1 Capital Ratio Under Adverse Scenario*

As at 31 December 2012

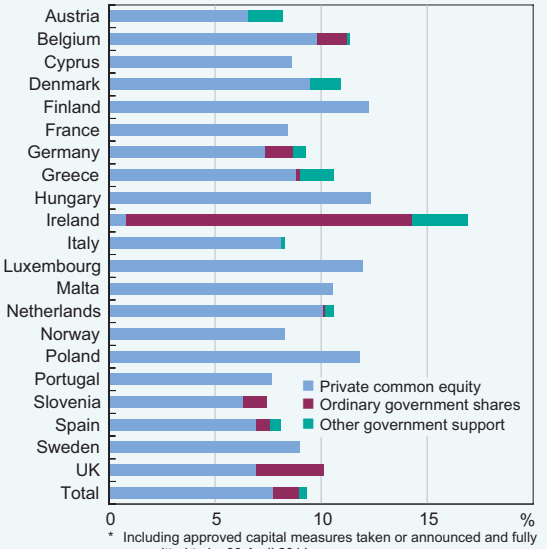


* Including approved capital and restructuring measures taken or announced and fully committed to by 30 April 2011

Source: EBA

Graph A2
Components of Banks' Core Tier 1 Capital Ratio*

As at 30 April 2011



* Including approved capital measures taken or announced and fully committed to by 30 April 2011

Source: EBA

banks' underlying profits, which were estimated to contribute about 3.7 percentage points to the aggregate capital ratio under the adverse scenario.

Estimated credit impairments were particularly large for some Irish and Greek banks, in part reflecting tougher economic and property market assumptions applied to these banks. Greek banks were also most affected by impairments on sovereign debt given the already low credit rating on Greek debt as at 1 June.

The participating banks' starting capital ratios were supported by recent capital raisings. In total, €50 billion in approved capital measures were undertaken or confirmed in the first four months of 2011, adding 0.4 percentage points to the aggregate core Tier 1 capital ratio. One-third of this capital was from government sources. As at end April 2011, 38 participating banks had received public capital support. Public capital accounted for an estimated 17 per cent of all participating banks' aggregate core Tier 1 capital, including capital measures that had been confirmed but not yet implemented at this time (Graph A2). Around three-quarters of this public capital support was through ordinary shares and the rest from other eligible instruments (for example, preferred shares). The extent of government support varied significantly across countries: there was no support in a number of countries (such as France and Sweden), while there was significant support in others (such as Germany and the United Kingdom). In Ireland, the large domestic banks are almost entirely owned by the Irish Government.

In conjunction with publishing the results of the stress test, the EBA also disclosed detailed information on participating banks' sovereign and other exposures to individual EU countries in order to enhance market transparency. The data on sovereign exposures were more extensive than the previous year in that they were broken down by maturity and included details on exposures arising from derivative positions. Participating banks

together held about €1.8 trillion in EU government debt at the end of 2010 (net of cash short positions), equivalent to 16 per cent of their risk-weighted assets, and a little under one-fifth of total EU general government debt outstanding (Table A1). On average, exposures to home-country sovereign debt represented about 60 per cent of participating banks' EU sovereign exposures. Their largest foreign EU sovereign exposures were to Germany and Italy, reflecting the sizeable amount of sovereign debt these countries have on issue.

Table A1: EU Banks' Net Sovereign Debt Exposures[(a) (b)]
As at 31 December 2010, € billion

	Country of debt issuance					
	Greece Portugal and Ireland	Italy	Spain	Other EU[(c)]	Total EU[(c)]	*Memo item: Domestic*
Sovereign debt held by banks in:						
Austria	0.6	1.2	0.2	43.3	**45.3**	*13.9*
Belgium	6.3	20.6	2.9	70.8	**100.5**	*26.3*
Cyprus	6.2	0.0	0.1	2.2	**8.5**	*1.4*
Denmark	0.5	0.4	0.1	13.6	**14.7**	*5.7*
Finland	0.0	–	0.0	0.9	**1.0**	*0.4*
France	15.0	41.1	9.3	199.2	**264.5**	*102.5*
Germany	12.0	32.9	17.1	363.8	**425.8**	*305.5*
Greece	48.4	0.1	–	3.6	**52.1**	*48.4*
Hungary	–	–	–	4.7	**4.7**	*4.3*
Ireland	10.4	0.8	0.3	5.3	**17.0**	*10.2*
Italy	1.9	159.0	3.0	38.4	**202.2**	*159.0*
Luxembourg	0.3	2.4	0.2	3.4	**6.2**	*2.9*
Malta	0.0	0.0	–	0.8	**0.8**	*0.7*
Netherlands	2.4	8.2	2.1	115.9	**128.6**	*44.0*
Norway	–	–	–	14.9	**14.9**	*14.3*
Poland	–	–	–	6.6	**6.6**	*6.6*
Portugal	20.9	1.0	0.3	1.9	**24.0**	*18.9*
Slovenia	0.1	0.1	0.0	2.6	**2.7**	*1.4*
Spain	6.0	6.6	222.3	9.6	**244.4**	*222.3*
Sweden	0.3	0.4	0.2	86.7	**87.5**	*25.2*
UK	4.8	11.5	6.6	164.6	**187.5**	*91.3*
Total	**136.1**	**286.3**	**264.4**	**1 153.0**	**1 839.7**	***1 105.2***
Memo item: General government debt outstanding	***637.1***	***1 843.0***	***638.8***	***6 852.7***	***9 971.7***	

(a) Gross long exposures (net of cash short positions)
(b) Of participating banks in EU stress test only
(c) Includes Norway
Sources: EBA; European Commission; RBA

Box B
The Global Reinsurance Industry

Reinsurance is a transaction where an insurer cedes all or part of an underwriting risk to a reinsurer in exchange for a premium. By transferring some of the risks they assume (known as cession), insurers can reduce risk concentrations and diversify their risk, which should reduce volatility in their net underwriting income and leave insurers more resilient to claims arising from large-scale events such as natural catastrophes.

Around 200 companies globally offer reinsurance – these firms' annual gross reinsurance premiums written totalled around US$200 billion in 2010, a small fraction of the US$4 trillion in primary insurance gross premiums. The global reinsurance industry is concentrated: the top 10 reinsurers accounted for nearly 65 per cent of industry gross premiums in 2010 and the top five reinsurers accounted for just under one-half (Table B1). Munich Re is the largest reinsurer in the world with gross premiums of US$31 billion in 2010, or 15 per cent of the total market. A number of large general insurers also write reinsurance business, although most companies offering reinsurance are specialised reinsurers.

Reinsurers domiciled in Bermuda, Germany, Switzerland, the United Kingdom and the United States account for the largest share of the reinsurance industry. European-domiciled reinsurers accounted for around 60 per cent of gross premiums written by the industry in 2010. The US-based reinsurers made up 15 per cent of gross premiums,

Table B1: Top 10 Global Reinsurers
Ranked by gross reinsurance premiums written in 2010

Rank	Company	Domicile	Gross premiums written US$ billion	Estimated market share Per cent
1	Munich Re	Germany	31.3	15
2	Swiss Re	Switzerland	24.8	12
3	Hannover Re	Germany	15.1	7
4	Berkshire Hathaway	United States	14.4	7
5	Lloyd's	United Kingdom	13.0	6
6	SCOR	France	8.9	4
7	Reinsurance Group of America	United States	7.2	4
8	Allianz	Germany	5.7	3
9	Partner Re	Bermuda	4.9	2
10	Everest Re	Bermuda	4.2	2
	Top 10		**129.4**	**64**
	Total market[a]		**203.3**	

(a) Estimate
Sources: A.M. Best Company; Swiss Re

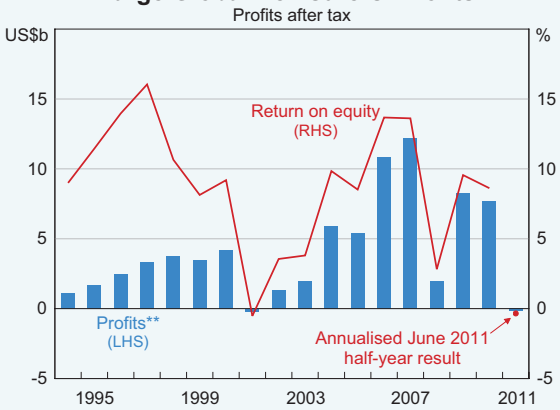
while Bermudian reinsurers accounted for 12 per cent. Despite European reinsurers' dominant market share, the United States is the biggest reinsurance market in the world reflecting the substantial value of insured property in catastrophe-prone areas. By region of the ceding primary insurer, North America accounts for the largest share of gross premiums assumed (about 45 per cent in 2009), while Europe's share is around 30 per cent, and Asia's is a little under one-fifth.

Non-life insurance accounts for the bulk of gross premiums assumed by reinsurers – around four-fifths in 2009, according to Swiss Re estimates. Primary insurers cede a higher share of non-life insurance premiums because many of the potential claims, such as those resulting from major catastrophes, are much larger and more clustered than life insurance claims. Also, some lines of non-life insurance are more specialised, meaning that primary insurers that assume these risks can potentially face risk concentration; ceding a relatively high proportion of these premiums to reinsurers helps to mitigate this problem.

Most of the largest reinsurers, such as Munich Re, Swiss Re, Hannover Re and Lloyd's, are highly diversified across geographical and business segments. While all of these reinsurers operate globally, Munich Re and Hannover Re are more focused on Europe, while Swiss Re and Lloyd's conduct a greater share of their business in the North American market. Non-life reinsurance accounts for the bulk of these reinsurers' gross reinsurance premiums, although Munich Re and Lloyd's also have significant primary insurance operations. Within the non-life segment, these reinsurers offer reinsurance across property and casualty lines as well as specialty segments, such as marine and aviation. Many smaller reinsurers are domiciled in Bermuda, playing a major role in the property catastrophe reinsurance market.

The profitability of the large global reinsurers has generally been solid since the mid 1990s. The annual after-tax return on equity across seven large reinsurers (the top 10 excluding Allianz, Berkshire Hathaway and Lloyd's) averaged about 10 per cent between 1995 and 2010, although returns were low or negative in the early 2000s and in 2008 (Graph B1). Investment earnings accounted for the majority of reinsurers' profits over this period, while the remainder was mainly due to their underwriting operations.

Graph B1
Large Global Reinsurers' Profits*



* Seven large global reinsurers; excludes Allianz, Berkshire Hathaway and Lloyd's due to data availability
** Data for 2011 are for the June 2011 half year
Sources: Bloomberg; company annual reports

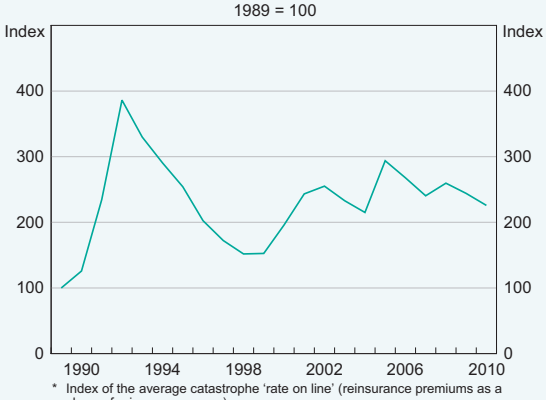
Reinsurers' investment income, along with that of many other insurers, declined during the 2008 crisis as equity prices fell and non-government bond spreads increased. Investment income has recovered somewhat since the crisis, although low interest rates continue to dampen returns. Fixed-income securities account for around 70 per cent of the seven large global reinsurers' investment portfolios, while loans and equity investments make up 16 per cent and 7 per cent, respectively. The proportion of equities in these reinsurers' investment portfolios has declined by 6 percentage points since the onset of the financial crisis, while the proportions in fixed-income securities and loans have increased

slightly. Large reinsurers generally have significant investments in sovereign debt, accounting for around one-half of their fixed-income portfolios in the cases of Munich Re, Swiss Re and Hannover Re; the bulk of these exposures are to German, UK and US sovereign debt. These reinsurers' exposures to the sovereign debt of Greece, Ireland, Italy, Portugal and Spain are relatively small. Munich Re's investments in Italian and Spanish sovereign debt together account for 10 per cent of its government bond portfolio, while Greek, Irish and Portuguese sovereign debt make up 4 per cent. Swiss Re's exposure to these countries is negligible and Hannover Re also has a very small exposure.

The recent spate of natural catastrophes has resulted in most reinsurers reporting an underwriting loss for their non-life operations in the half year to June 2011. Aggregate catastrophe claims from the natural disasters occurring in the first half of 2011 are estimated to be around US$70 billion, the second highest (inflation-adjusted) level of claims for any calendar year since 1970 (see Graph 1.19 in the chapter on 'The Global Financial Environment').[1]

Historically, reinsurers' underwriting performance has been significantly affected by catastrophe events, and the impact of major catastrophes is evident in reinsurance price cycles. Most notably, global catastrophe reinsurance premium rates increased sharply following Hurricane Andrew in 1992 (Graph B2). Premium rates declined during the mid to late 1990s as high prices earlier in the decade encouraged the expansion of reinsurance supply and new entrants into the reinsurance market. Many of these new entrants were based in Bermuda because of its relatively favourable regulatory and tax regimes. Prices for catastrophe reinsurance increased again following the terrorist attacks on September 11, 2001, and Hurricane Katrina in 2005. However, the price cycle was more moderate in these cases as capital flowed to reinsurers more quickly, partly due to the Bermudian reinsurance market's more advanced stage of development and the increasing role of hedge funds in providing capital to the reinsurance industry.

Graph B2
Global Catastrophe Reinsurance Premium Rates*



* Index of the average catastrophe 'rate on line' (reinsurance premiums as a share of reinsurance cover)
Source: Bloomberg

Reinsurance contributes to financial stability in a number of ways. Reinsurers absorb some of the underwriting risks primary insurers face, and therefore indirectly support the balance sheets of households and businesses using primary insurance services. Without reinsurance, some primary insurers might not underwrite certain risks as they would be unwilling to take on the entire risk themselves.[2] Along with primary insurers, reinsurers are significant investors in financial markets. Through their investments, reinsurers are a source of funding for banks, non-financial corporates and sovereigns, and their long-run investment horizons are generally stabilising in these markets.

1 Long-run data on catastrophe claims do not account for factors such as increased population density and property development over time.

2 Reinsurance cover plays an important role in the business models of Australian general insurers, as well as the Australian Prudential Regulation Authority's risk-based capital requirements. For further discussion, see RBA (2011), 'Box B: Reinsurance and the Australian General Insurance Industry', *Financial Stability Review*, March, pp 39–41.

Reinsurance can in theory also pose risks to financial stability. Reinsurers assume underwriting risks from primary insurers (cession) and from other reinsurers (retrocession). If a reinsurer were to fail, the ceding insurer would be liable for any claims that they had ceded to that reinsurer. That could raise reinsurance premiums or disrupt the primary insurance industry. Loss of reinsurance cover might cause primary insurers and other reinsurers to scale back their underwriting activities. If this occurred, households and businesses may find it harder to insure themselves against risk, which in turn could adversely affect economic activity. However, disruptions in reinsurance supply are likely to be temporary as higher prices would likely attract new capital and encourage reinsurers to increase supply. Some industry observers, including the International Association of Insurance Supervisors (IAIS), think this could happen quite quickly and, as noted above, the flow of new capital invested in the reinsurance industry following major catastrophes in 2001 and 2005 is consistent with this.[3] Reinsurance cover could also be expanded by existing reinsurers transferring some of the underwriting risks they assume to capital markets through issuing insurance-linked securities such as catastrophe bonds.

Some aspects of reinsurers' business models make it less likely that they will suffer financial distress compared with banks. Reinsurers are less leveraged than banks and their liabilities are pre-funded by premiums, so they are typically not reliant on debt markets for funding. Unlike banks, reinsurers do not have to pay out liabilities on demand; rather, their liabilities are contingent on claims arising after underwriting risks materialise. Like banks, reinsurers are subject to prudential standards; European Union regulators are in the process of implementing a new regulatory regime (Solvency II) designed to make minimum regulatory capital requirements for insurers and reinsurers more risk-sensitive.

3 IAIS (2010), 'Position Statement on Key Financial Stability Issues', 4 June.

2. The Australian Financial System

As noted in the chapter on 'The Global Financial Environment', concerns about the sustainability of sovereign debt and the strength of the global economic recovery have intensified over August and September. This has resulted in a tightening in global credit markets and heightened volatility in the Australian share market as well as those overseas. Australian bank share prices fell sharply in early August and remained volatile during September; they are now around 10 per cent below their levels at the start of August. Relative to its pre-crisis position, though, the Australian banking system is better placed to cope with such adverse shocks. It has higher levels of capital, makes less use of short-term wholesale funding and makes greater use of deposits as a source of funding. Bank profitability continues to improve following the financial crisis, largely due to falls in charges for bad and doubtful debts.

On the other hand, should conditions deteriorate materially, the effect on the banking system would occur from a somewhat weaker starting position on asset quality than had been the case at the beginning of the crisis. Despite the favourable macroeconomic environment and low unemployment in Australia, the proportion of non-performing assets on banks' balance sheets remains close to its recent peak, though it is well below the levels seen in the early 1990s and those currently experienced in many other developed countries. The bulk of non-performing housing loans are well collateralised and therefore not likely to lead to material loan losses. However, with house prices softening, borrowers cannot sell their property as easily if they get into payment difficulty, meaning fewer cases of arrears are likely to be resolved by the sale of the property than when prices were rising. It may also be harder for borrowers in difficulty to refinance with another lender, as the non-authorised deposit-taking institution (non- ADI) sector is not refinancing as many existing ADI loans as in the past and, overall, lending standards remain tighter than before the crisis.

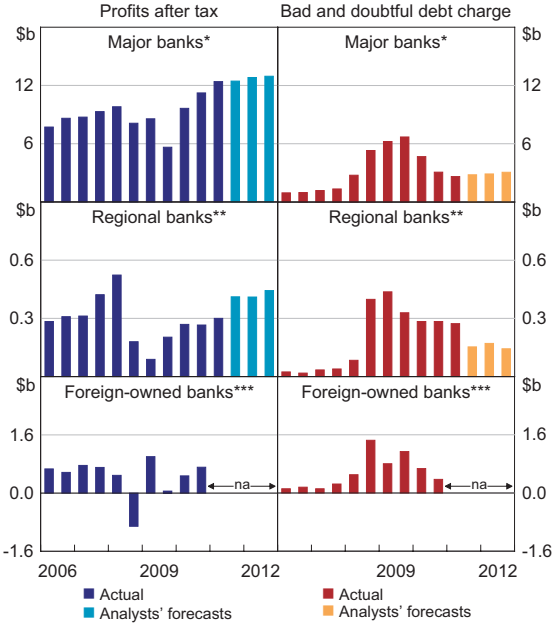
Subdued credit growth will affect the outlook for future increases in the profitability of ADIs. In such an environment of low credit growth, it will be important that ADIs do not seek to imprudently expand their balance sheets by easing lending standards, or by taking on excessive risks in unfamiliar markets or products. In these circumstances, shareholders may need to revise their expectations about the future growth in ADI profits.

The Australian insurance industry reported lower profits in the March quarter 2011, due to a weaker underwriting result, although this was, in part, offset by stronger investment income, and profits recovered in the June quarter. Insurers coped well with the elevated levels of claims from the natural disasters around the start of 2011, assisted by their robust reinsurance arrangements. Insurers have begun to raise premiums, particularly on home insurance, to cover rises in reinsurance premiums.

Banking System Profits

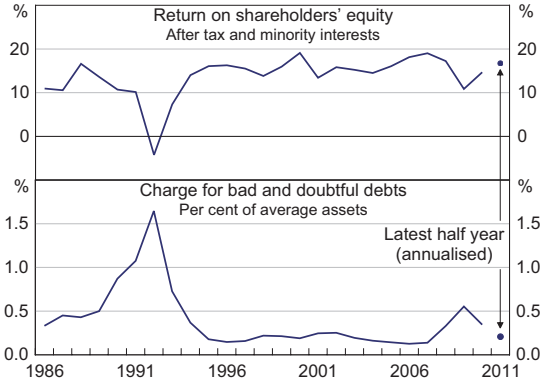
The four major banks reported aggregate headline profits after tax and minority interests of $12.4 billion in their latest available half-yearly results (Graph 2.1 and Table 2.1). Excluding a one-off tax write-back at one of them, these banks' profits were $1.6 billion

Graph 2.1
Bank Profits



* 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; Credit Suisse; Deutsche Bank; RBA; UBS Securities Australia; banks' annual and interim reports

Graph 2.2
Major Banks' Profitability*



* From 2006 data are on an IFRS basis; prior years are on an AGAAP basis
Sources: RBA; banks' annual and interim reports

(17 per cent) higher than in the same period a year earlier. The major banks' average return on equity in the latest half year was 17 per cent in annualised terms, which is broadly in line with the pre-crisis average (Graph 2.2). The increase in profitability in the latest half year was largely driven by a further reduction in bad and doubtful debt charges. Underlying revenue growth was steady at around 4 per cent over the same period a year earlier, comparable to the growth rate in the past couple of years, but well down on pre-crisis rates. Aggregate bad and doubtful debt charges were $2.6 billion in the latest half year, down about 60 per cent from the 2009 peak, though still above the pre-crisis average. As discussed further below, the major banks' non-performing assets have levelled out recently, but are yet to show a marked decline from their recent peak.

Net interest income, the main source of income for these banks, rose by 5 per cent over the year, a slower rate of growth than in earlier periods. This reflected

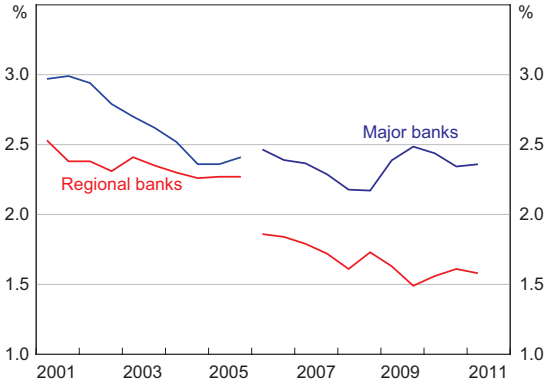
Table 2.1: Major Banks' Half-yearly Profit Results[(a)]
Consolidated global operations

	2010 $billion	2011 $billion	Change $billion
Income			
Net interest income	23.1	24.2	1.1
Non-interest income	10.7	11.0	0.4
Expenses			
Operating expenses	15.7	16.5	0.8
Bad and doubtful debts	4.7	2.6	–2.1
Profit			
Net profit before tax	13.4	16.1	2.7
Net profit after tax and minority interests	9.6	12.4	2.8

(a) Half year to March for ANZ, NAB and Westpac; half year to June for CBA
Sources: RBA; banks' annual and interim reports

subdued growth in interest-earning assets. The average net interest margin was also down slightly over the year, but was broadly steady compared with the previous half year (Graph 2.3). Non-interest income increased by 3 per cent over the year, as a rise in revenue from the banks' wealth management and life insurance operations more than offset lower trading and investment income. The major banks with general insurance operations also reported lower income from this source due to increased claims associated with the natural disasters earlier in the year. However, general insurance income only accounts for a very small share of these banks' operating income.

Graph 2.3
Banks' Net Interest Margin*
Domestic operations



* From 2006 data are on an IFRS basis; prior years are on an AGAAP basis
Sources: RBA; banks' annual and interim reports

The profitability of the major banks' overseas operations, which account for about one-quarter of their consolidated profits in aggregate, has generally strengthened in the past year. In part, this reflects an improvement in their New Zealand operations, which has been supported by economic recovery and improving asset quality.

The major banks that released their June quarter trading updates in mid August reported mixed profit results for the quarter, characterised by softer trading income and higher net interest margins. Looking ahead, equity market analysts are forecasting more modest increases in the major banks' profits in 2012, as bad and doubtful debt charges are expected to level out and credit growth to remain weak. Analysts believe that if the major banks are to improve their profitability in this environment, they will need to reduce their costs, even though their cost-to-income ratios are already among the lowest in the world. The major banks' headline cost-to-income ratio was mostly unchanged in their latest half-year results and remains in line with the average since 2008.

The regional Australian banks' latest half-yearly profits increased slightly compared with the previous year, with modest revenue growth supported by a small further decrease in bad and doubtful debt charges. Though their profits, in aggregate, have recovered noticeably since 2009, they remain below pre-crisis levels. The slower profit recovery compared with the major banks reflects a more modest decline in the regional banks' bad and doubtful debt charges since their 2009 peak, slower asset growth and a weaker trend in net interest margins. The latest half-yearly results for the two regional banks with a larger relative exposure to Queensland were adversely affected by the natural disasters there in early 2011. However, analysts generally expect these effects to be temporary and have forecast growth in profits and a reduction in bad and doubtful debt charges for these banks in the second half of 2011.

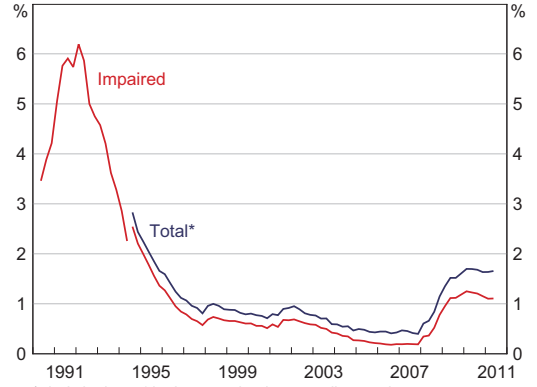
The foreign-owned banks operating in Australia recorded a further increase in their profits in the six months to December 2010, assisted by falls in bad and doubtful debt charges at the foreign bank branches. In aggregate, the foreign banks' profits are now broadly similar to the levels recorded between 2006 and mid 2008. Aggregate profits for credit unions and building societies (CUBS) have also increased steadily since late 2009 and are now above pre-crisis levels.

Asset Quality

Banks' asset performance has been broadly steady over recent quarters, with the ratio of non-performing assets to total on-balance sheet assets hovering around 1.7 per cent since early 2010 (Graph 2.4). Of this, the ratio of impaired assets – consisting

Graph 2.4
Banks' Non-performing Assets

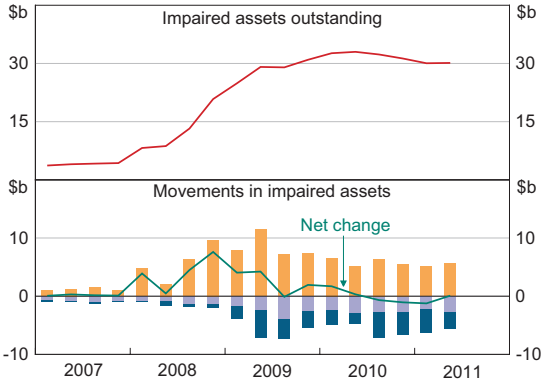
Consolidated global operations, per cent of on-balance sheet assets



* Includes items 90+ days past due that are well secured
Source: APRA

Graph 2.5
Banks' Impaired Assets

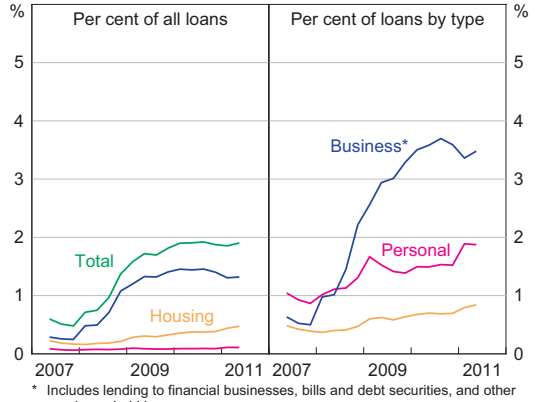
Consolidated global operations



Source: APRA

Graph 2.6
Banks' Non-performing Assets

Domestic books



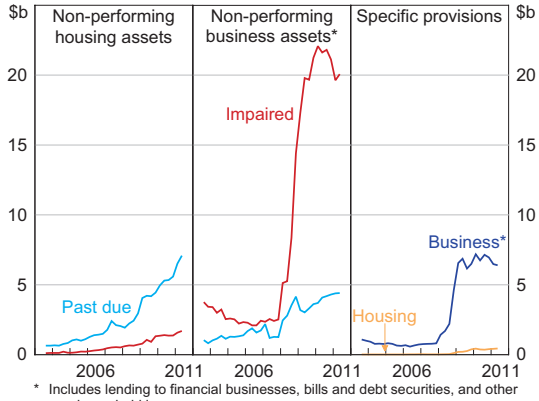
* Includes lending to financial businesses, bills and debt securities, and other non-household loans
Source: APRA

mostly of facilities that are not well-collateralised – has declined slightly to about 1.1 per cent in June, down from 1.3 per cent in March 2010. The rate at which loans have been moving out of impairment due to write-offs or 'curing' has exceeded inflows of newly impaired assets in recent quarters, causing a slight decrease in the level of impaired assets (Graph 2.5). The remaining component of non-performing assets is 'past-due' loans – those that are well covered by collateral but have repayments overdue by at least 90 days. The ratio of past-due loans to total on-balance sheet loans was 0.5 per cent in June, up from 0.4 per cent in March 2010. Even though the banks' total non-performing assets ratio remains around 80 basis points above its average over the past decade, it is still well below the early 1990s peak of over 6 per cent. It also compares favourably with the non-performing asset ratios seen in some other developed countries.

In the banks' domestic portfolio, the ratio of non-performing loans to total on-balance sheet loans has been broadly steady, at around 1.9 per cent, since September 2010 (Graph 2.6). The business loan portfolio has improved modestly, such that the non-performing share has fallen by 20 basis points to 3.5 per cent since September 2010. By contrast, the share of banks' housing loans that are non-performing has drifted up over this period, to around 0.8 per cent in June.

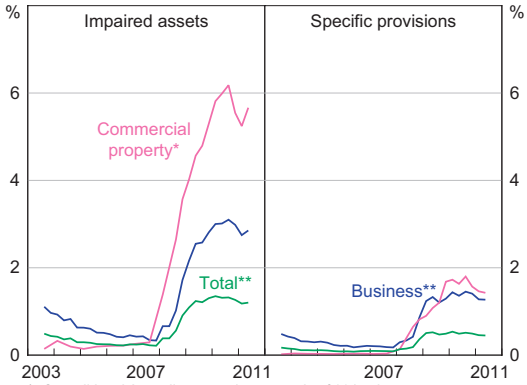
Unlike non-performing business loans, most non-performing housing loans are classified as past due rather than impaired and it is this past-due component that has increased most over the past year (Graph 2.7). As discussed further in the 'Household and Business Balance Sheets' chapter, much of the recent increase in housing arrears is due to loans that were taken out prior to 2009 when lending standards were weaker, with more recent loans tending to perform better. Because the bulk of these loans are well collateralised, and likely to remain so even if housing prices were to fall significantly, lenders' housing loan losses should remain low.

Graph 2.7
Banks' Asset Quality
Domestic books



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

Graph 2.8
Banks' Asset Quality
Per cent of loans by type



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

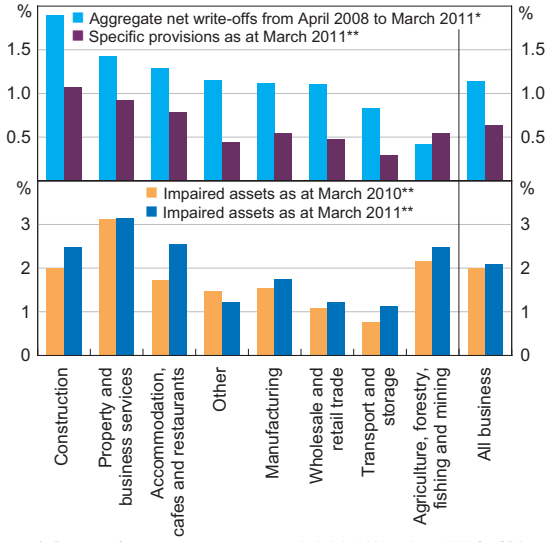
A concern would arise if the extent of provisioning for these non-performing assets proved to be inadequate, which would weigh on future profit growth. In the current circumstances, it is likely that fewer cases of arrears will be resolved by the voluntary sale of the property than when housing prices were rising. As well, arrears rates in ADIs' own books may be behaving differently from the past: for example, the decline in the securitisation market may have resulted in some higher-risk borrowers who in previous years would have gone to the non-ADI sector, instead taking out loans from ADIs. The decline in the non-ADI sector also means these lenders are not refinancing as many existing ADI loans as in the past, which might otherwise have removed some loans at risk of falling into arrears from ADIs' books. Even though lending standards have tightened in the market overall as a result of these developments, individual lenders might find their own asset quality has deteriorated.

In the banks' domestic business loan portfolios, troubled commercial property exposures have been the main contributor to the high impairment rate in recent years. The share of commercial property loans that is impaired increased by about 40 basis points over the June quarter, to 5.7 per cent, although this is below its recent peak of 6.2 per cent in September 2010 (Graph 2.8). Much of the fall in impaired commercial property assets from the recent peak has been due to the liquidation of a small number of sizeable bad debts. Consistent with the sale of this debt, specific provisions held against impaired commercial property exposures have generally declined since December 2009. The impairment rate for other types of business loans has also moderated over 2011, but it is still higher than average.

More detailed data from the major banks' Basel II Pillar 3 disclosures show that business loan write-off rates since early 2008 have been above average in the construction, property and business services (incorporating commercial property), and accommodation, cafes and restaurants sectors (Graph 2.9). Impairment rates remain above average in these sectors, and are also high for the agriculture, forestry, fishing and mining industry. The relatively large increase in the impairment rate on loans to the accommodation, cafes and restaurants sector over the year to March is reportedly partly due to the difficulties of some operators of pubs, clubs and hotels.

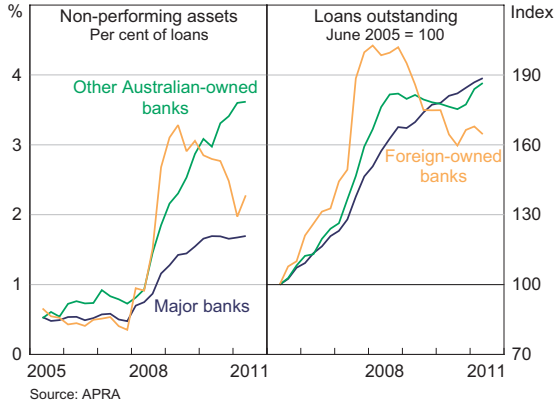
The major banks' domestic non-performing assets ratio has been broadly steady over the past year, at about 1.7 per cent, remaining below that of the smaller Australian-owned banks and foreign-owned banks (Graph 2.10). The share of non-performing assets on the foreign banks' books has declined

Graph 2.9
Loan Losses and Asset Quality by Industry
Major banks' consolidated global operations, per cent of industry exposures



* Per cent of average exposures over period; July 2008 to June 2011 for CBA
** June of each year for CBA
Source: Banks' Basel II Pillar 3 reports

Graph 2.10
Banks' Asset Quality and Loans
Domestic books



Source: APRA

from a peak of about 3.3 per cent in mid 2009 to 2.3 per cent in June 2011. By contrast, the equivalent ratio for the smaller Australian-owned banks has continued to rise over recent quarters, reaching 3.6 per cent in June 2011, despite a turnaround in loans outstanding. The deterioration in loan performance has been evident across all portfolios, though commercial property exposures continue to account for the bulk of these smaller banks' impaired assets. The non-performing share of CUBS' loans has also increased, although it remains much lower than that for the banks, partly reflecting that a larger share of CUBS' loans is to households.

The performance of the Australian-owned banks' overseas assets has continued to improve in recent quarters. Since peaking in mid 2010, the ratio of non-performing overseas assets to total on-balance sheet assets has fallen from 0.4 per cent to 0.3 per cent in June 2011, although it remains above the pre-crisis level. The Australian banks' offshore operations to date have largely been concentrated in New Zealand and, to a lesser extent, the United Kingdom. Entities in New Zealand account for around 40 per cent of Australian-owned banks' foreign exposures, arising mainly through the major banks' New Zealand-based operations. Loan performance in New Zealand has been improving recently as the economic recovery has strengthened. Asset quality at the banks' UK operations – about 20 per cent of their overseas assets – remains weaker.

Australian banks report little direct exposure to the euro area sovereigns regarded as being most at risk, and as at end March, none at all to Greek sovereign risk. Likewise, their exposures to euro area banks are low, accounting for less than 10 per cent of their total foreign claims and under 2 per cent of their total assets as at March (Table 2.2). The vast bulk of these exposures are to banks from the larger euro area countries, namely France, Germany and the Netherlands. Australian banks' exposures to banks from the countries in the euro area that have experienced the most severe fiscal difficulties are very small and have declined over the past year.

Lending Growth and Credit Conditions

Banks' domestic lending has been growing at a subdued pace in recent years, as both households and businesses remain cautious in their borrowing behaviour. Bank lending to households increased by 4.9 per cent in annualised terms over the six months to July, down from 7.4 per cent in the six months to January 2011 (Graph 2.11). In recent

Table 2.2: Australian Bank Claims on the Euro Area[(a)]
Ultimate risk basis, as at March 2011

	Total		*of which:*		
			Banks	Public sector	Private sector
	$billion	Per cent of assets	Per cent of assets	Per cent of assets	Per cent of assets
Euro area	**55.9**	**1.9**	**1.2**	**0.2**	**0.5**
of which:					
Greece, Ireland, Italy, Portugal and Spain	7.8	0.3	0.1	0.0	0.2
France, Germany and the Netherlands	44.1	1.5	1.1	0.2	0.3

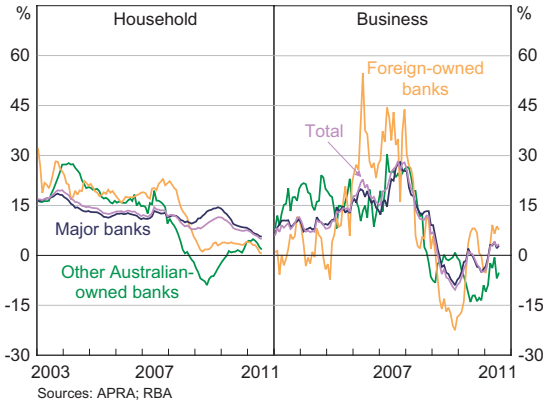
(a) Australian-owned banks and subsidiaries of foreign-owned banks; exposures include those to foreign-owned banks booked in Australia
Source: APRA

years, the foreign-owned and smaller Australian-owned banks have seen slower growth in their household lending than the major banks.

After contracting over much of the past two and a half years, bank lending to businesses expanded by 3.4 per cent in annualised terms over the six months to July, though monthly data point to it being flat in recent months. There has been some variation across institutions, with foreign-owned banks experiencing a more pronounced pick-up in their business lending, while lending by the smaller Australian-owned banks has continued to contract. There was a modest increase in bank credit to both non-financial corporations and unincorporated businesses over the first half of the year, while bank lending to financial corporations declined (Graph 2.12). Recent industry liaison indicates that demand for credit by businesses remains quite weak, mainly reflecting businesses' uncertainty about the economic outlook and subdued conditions in sectors most exposed to the strong Australian dollar and weak retail spending.

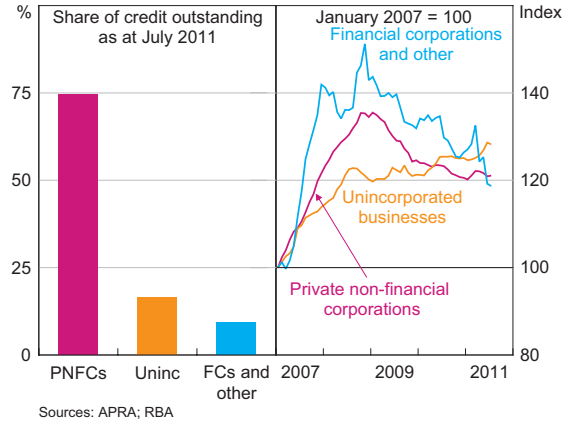
As the more cautious approach to borrowing by households and businesses is unlikely to change in the near term, lenders are having to adapt to much slower rates of credit growth than they were accustomed to in the pre-crisis period. Adapting to this environment will help avoid the risks that would be involved in trying to sustain earlier growth rates, for example by

Graph 2.11
Bank Credit Growth
Six-month-ended, annualised



Sources: APRA; RBA

Graph 2.12
Business Credit by Borrower



Sources: APRA; RBA

lowering lending standards or imprudently expanding into new products or markets.

There has been an increase in competition in the residential mortgage market in the past year. Signs of increased competition recently include higher discounts being offered on housing loans, lower fees and increases in maximum allowable loan-to-valuation ratios from 90 to 95 per cent. There has been an increase in mortgage refinancing activity in recent months as borrowers have sought better deals, exit fees have been removed or reduced and a greater volume of fixed-rate loans have matured than is typical.

However, in some other respects, lending standards remain tighter than before 2009. The share of low-doc lending has continued to fall in recent years, partly in response to the recent introduction of more stringent responsible lending guidelines that require lenders to verify a borrower's capacity to repay. Lenders also have more conservative debt-serviceability requirements than they did in earlier years, including using higher interest-rate buffers in their assessments of repayment capacity. As discussed further in the 'Household and Business Balance Sheets' chapter, recent mortgage borrowers have tended to perform better than earlier cohorts, even with the recent increases in interest rates, which is consistent with a tightening of lending standards since 2008.

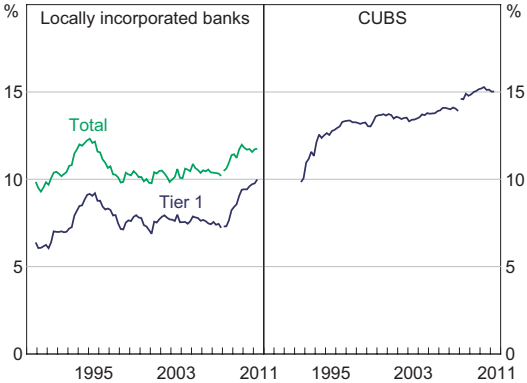
In business lending, competitive pressure to ease lending standards has generally been less intense than in the residential mortgage market. While margins have reportedly continued to narrow in the wholesale segment, margins on other business loans have been little changed over the past year.

Capital

The Australian banking system remains well capitalised, with the aggregate Tier 1 capital ratio increasing by a further 0.3 percentage points over the six months to June, to 10 per cent of risk-weighted assets (Graph 2.13). This increase was mostly due to dividend reinvestments and a sizeable proportion of earnings being retained in their latest half-yearly results; risk-weighted assets were broadly unchanged over this period. Banks have continued to run down their stocks of subordinated debt over recent years, resulting in a decline in Tier 2 capital. They have done so because these instruments in their current form will not be eligible to be included in capital under the Basel III framework after the transition period ends. Credit unions and building societies have maintained their higher capital ratios, with the aggregate Tier 1 capital ratio around 15 per cent in June.

From a longer-run perspective, the Australian banks' Tier 1 capital ratio has increased substantially since 2007 as they have responded to market pressures for banks globally to hold more capital as well as in anticipation of tougher regulatory requirements. As a result, the Australian banks are well placed to meet the new Basel III capital adequacy requirements with high-quality capital such as common equity and retained earnings. As noted in the 'Developments in the Financial System Architecture' chapter, the Australian Prudential Regulation Authority (APRA) has recently released a consultative document on how it intends to implement the Basel III framework in Australia, with a faster timetable in certain key areas than the global requirements.

Graph 2.13
Capital Ratios
Per cent of risk-weighted assets*

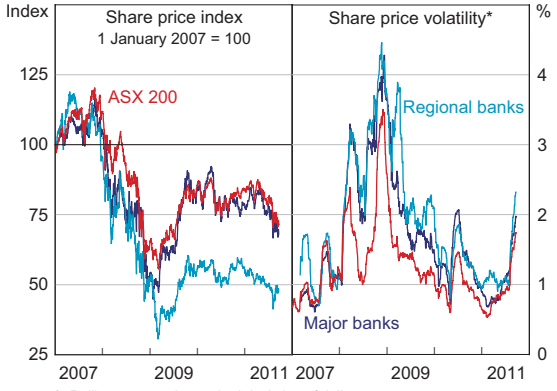


* Break in March 2008 due to the introduction of Basel II for most ADIs
Source: APRA

Financial Markets' Assessment

After a period of relative stability for much of the past year, there was a sharp increase in the volatility of Australian bank share prices in August and September associated with the turbulence in global financial markets. Bank share prices have fallen by around 10 per cent since the start of August, although there have been some sizeable swings during this period (Graph 2.14). These movements in bank share prices have generally been in line with the broader share market over this time. The increased market uncertainty during August and September was also reflected in increases in Australian banks' credit default swap (CDS) premia – the price investors pay to insure against the default on bank debt – but to a lesser extent than those of many large banks overseas.

Graph 2.14
Financial Market Indicators



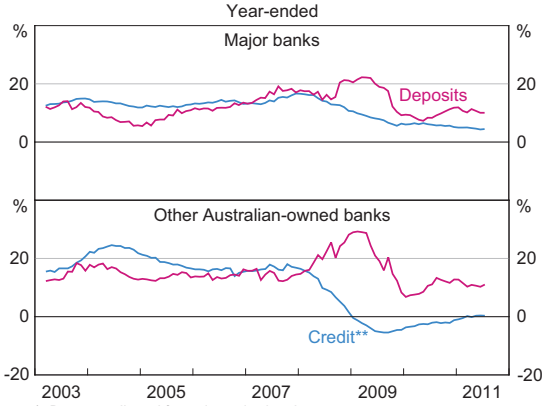
* Rolling two-month standard deviation of daily returns
Sources: Bloomberg; RBA

The major banks continue to be viewed favourably by the international credit rating agencies. A decision by Moody's to downgrade the credit ratings of the major banks by one notch in May, from Aa1 to Aa2, had minimal market impact, as it was well anticipated and only brought Moody's ratings into line with those of Standard & Poor's (S&P). Moody's decision was primarily based on its reassessment of the risks associated with these banks' offshore wholesale funding, though the agency also considered the official sector to be supportive relative to many other jurisdictions. There have also been several changes to the credit ratings of the regional banks in the past six months. S&P is still reviewing its global bank credit rating methodology and at this stage, it is expected to announce the outcome of its review later this year.

Funding Conditions and Liquidity

Overall, Australian banks have faced a favourable funding environment for much of the past year, though the latest bout of global market uncertainty has caused some tightening of wholesale funding conditions since July. Growth in deposits has remained strong over the past six months, averaging over 10 per cent on an annual basis, and continuing to exceed credit growth by a significant margin (Graph 2.15). Within this, there has been strong growth in deposits from both households and businesses, and across most types of ADIs. Underlying this growth in deposits has been an increase in the rate of household saving in recent years, some of which has flowed to the ADI sector, and robust growth in business sector profits, particularly in the resources sector. Competition in the deposit market has abated somewhat recently, especially for wholesale deposits, partly because banks are becoming more discriminating as they take into account the liquidity implications of these deposits under the Basel III liquidity rules.

Graph 2.15
Bank Credit and Deposit Growth*



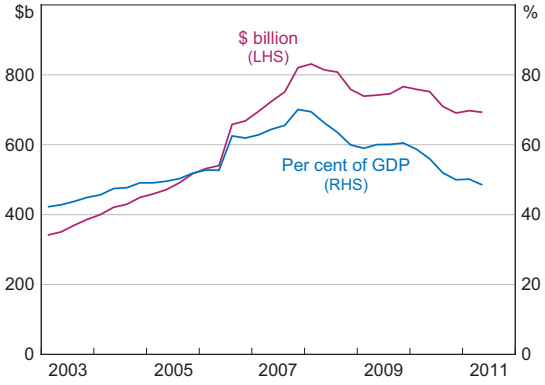
* Data are adjusted for major series breaks
** Includes securitisations
Sources: APRA; RBA

As a result of the rapid growth of deposits and subdued growth in credit over a number of years now, the difference between ADIs' loans and deposits – a measure of the funding that needs to be filled from wholesale and other sources – has declined by about one-sixth since 2008, to around $700 billion in June (Graph 2.16). Consistent with this, domestic deposits now account for about one-half of banks' funding liabilities, up from two-fifths in 2008 (Graph 2.17). As well as increasing the share of their funding from deposits, banks have also sought to lengthen the maturity of their wholesale funding over recent years in response to market and regulatory pressure. Short-term wholesale funding has fallen from about one-third of total bank funding in 2007 to around one-fifth during the past year, while the long-term wholesale funding share has risen from about one-sixth to more than one-fifth over the same period.

Banks maintained good access to domestic and offshore wholesale bond markets during the past year. Their reduced wholesale funding requirement has allowed them to take a more opportunistic approach to their bond issuance, issuing when pricing has been most attractive. Over the eight months to end August, the value of bonds issued was slightly less than matured, so the value of bonds outstanding fell (Graph 2.18). Banks also raised less wholesale funding from offshore than matured in the past year meaning that, in net terms, they have been repaying some of their foreign liabilities. While Australian banks have had limited bond issuance since July, discussions with the banks indicate that many of them are already ahead on their wholesale funding plans for the year, allowing them to hold back from issuing bonds during periods of heightened market volatility.

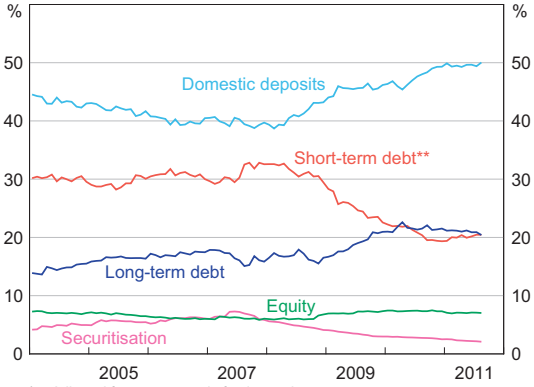
While there has been some tightening in wholesale funding conditions due to the recent global market turbulence, the overall effect has been modest compared with some other countries, and to conditions globally in 2008. Domestic secondary

Graph 2.16
ADI Credit less Deposits*



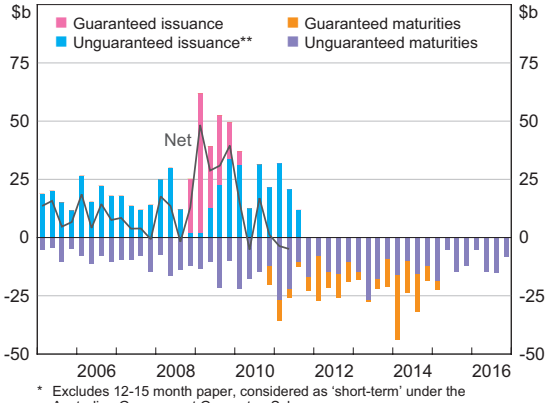
* Credit includes securitisations; deposits exclude intra-group deposits
Sources: ABS; APRA; RBA

Graph 2.17
Banks' Funding*
Per cent of total



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

Graph 2.18
Banks' Bond Issuance and Maturities*
A$ equivalent



* Excludes 12-15 month paper, considered as 'short-term' under the Australian Government Guarantee Scheme
** September 2011 is quarter-to-date
Source: RBA

market spreads on the major banks' three-year debt, for instance, have traded within a range of about 110 to 150 basis points over Commonwealth Government securities (CGS) over the past six months compared with around 200 basis points for most of 2008 (Graph 2.19).

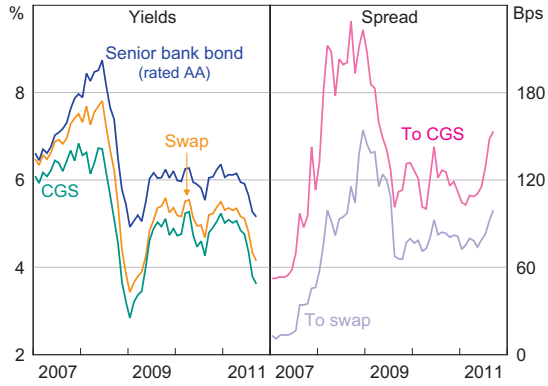
Some banks have repurchased their government-guaranteed bonds that have around one year or less left before maturity and replaced them with unsecured debt. In total, banks bought back around $13 billion of their guaranteed bonds over the past year. Many of these repurchases were securities that mature in the first quarter of 2012, a period of larger-than-average maturities of guaranteed bonds. Together with the $23 billion of guaranteed bonds that matured over the past year, repurchases have helped reduce banks' guaranteed wholesale liabilities outstanding, to around $120 billion in August, down from around $155 billion in mid 2010.

Conditions in the residential mortgage-backed securities (RMBS) market have generally improved this year. Issuance in the first half of 2011 was the strongest since 2007, with the major banks accounting for around one-half (Graph 2.20). A tightening of spreads in the secondary market has supported primary transactions and reduced the extent of support by the Australian Office of Financial Management, which only participated in around one-half of the number of transactions this year (7 per cent of the value). While there has been some issuance of commercial mortgage-backed securities this year, it remains very low compared with pre-crisis levels.

Banks have continued to increase their holdings of liquid assets, such as cash, deposits and highly marketable securities. Of this, government securities now make up a larger share than prior to the crisis, although the proportion has been stable for a couple of years. As banks have also reduced their use of short-term wholesale funding, the ratio of liquid assets to short-term wholesale liabilities has increased strongly over recent years.

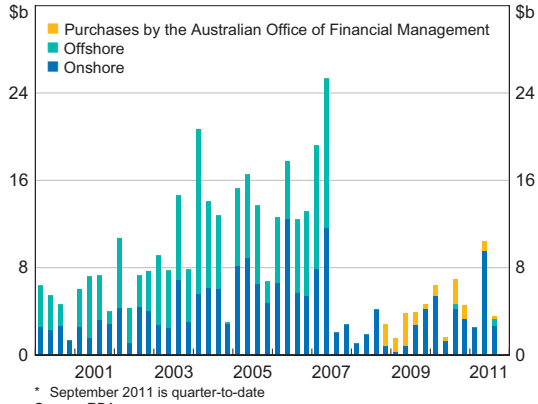
Overall, with higher capital levels and a stronger liquidity and funding position, the Australian banking system is better placed to cope with periods of market strain than it was before the crisis.

Graph 2.19
Major Banks' Bond Pricing
3-year A$ debt



Sources: Bloomberg; RBA; UBS AG, Australia Branch

Graph 2.20
Australian RMBS Issuance*
A$ equivalent, quarterly

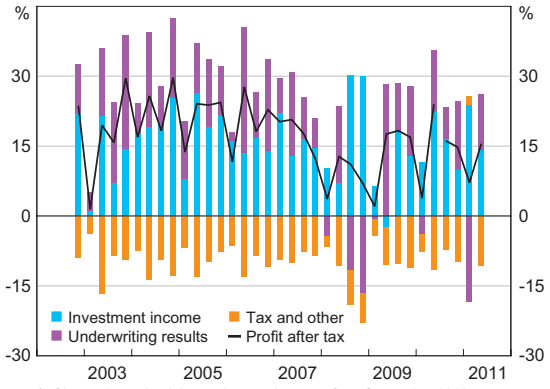


* September 2011 is quarter-to-date
Source: RBA

General Insurance

Following the natural disasters early in the year, the general insurance industry reported lower profits in the March quarter 2011, although profits have since recovered. A large underwriting loss in the March quarter was partly offset by stronger investment returns, so the annualised return on equity only dipped to 7 per cent, before returning to about 16 per cent in the June quarter on an improved underwriting result (Graph 2.21). An important factor limiting the financial impact of the disasters in the March quarter has been the insurers'

Graph 2.21
General Insurers' Performance*
Contribution to return on equity, annualised



* Change in prudential reporting requirements from September 2010
Source: APRA

reinsurance arrangements, as around three-quarters of the claims relating to the recent Australian natural disasters were covered by reinsurance with private-sector reinsurers. Australian insurers' exposure to the 2010 and 2011 Christchurch earthquakes is also significantly limited by reinsurance, particularly from the New Zealand government-owned Earthquake Commission. The estimated claims, net of reinsurance, on Australian insurers resulting from the March 2011 Japanese earthquake and tsunami were relatively small. The only Australian insurer with a notable exposure to the Japanese disasters is QBE, with estimated claims of US$137 million, net of reinsurance, mainly coming from its marine and energy insurance business lines.

As a result of the natural disasters, insurers are facing higher reinsurance costs and have started to pass these on through higher premiums, particularly on home insurance policies. Estimates of the increases in insurers' reinsurance premiums vary widely, but most are in the range of 20 to 60 per cent, which is expected to translate to an average premium increase for consumers of about 5 to 10 per cent.

The Government has established the Natural Disaster Insurance Review to examine the availability and affordability of natural disaster insurance, with a focus on flood insurance, given that many insured homes affected by the Queensland floods did not have cover for riverine flooding. The Review estimates that around 3 to 6 per cent of homes across Australia face a modest level of flood risk, and 1 per cent face a high risk of flooding. In its preliminary report, the Review has canvassed three options:

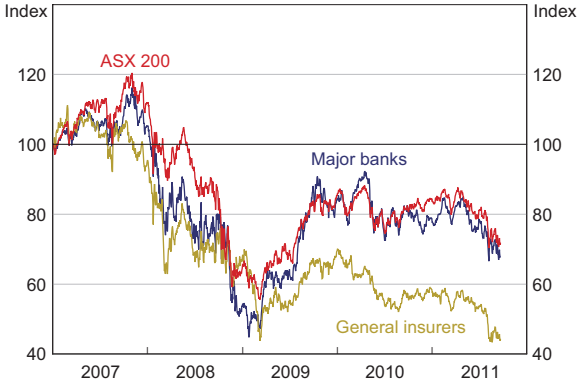
1. Automatic flood cover;
2. Automatic flood cover with the ability to 'opt out'; or
3. No change to the existing practice.

The automatic flood cover options could be accompanied by a premium subsidy for home owners in high-risk areas. The argument for a subsidy is that the premiums in high-risk areas could otherwise be prohibitively high, and some home owners may choose not to have insurance. The Review is currently considering submissions and is expected to submit its final report to the Government by the end of September 2011. In the meantime, a growing number of policies offer riverine flood cover and the Insurance Council of Australia expects this to increase to over 80 per cent of policies sold by January 2013, as additional flood mapping becomes available.

The general insurance industry coped well with the elevated level of claims and remains well capitalised, holding capital as at June 2011 equivalent to about 1.8 times APRA's minimum capital requirement. This was down from 1.9 times as at December 2010. APRA is continuing its review of general insurers' capital standards, with the aim of making them more risk-sensitive and to harmonise the capital framework for life and general insurance. The review will also more closely align the insurance capital framework with that for ADIs, where appropriate.

Insurers' strong capital levels are reflected in their high credit ratings: the Australian operations of the largest insurers are rated A+ or higher by S&P. The large Australian insurers' share prices are down by more than 20 per cent since the beginning of the year, compared with a fall of about 15 per cent for the broader market, which is similar to the movements of overseas insurers relative to broad market indices (Graph 2.22).

Graph 2.22
Share Prices
1 January 2007 = 100



Sources: Bloomberg; RBA

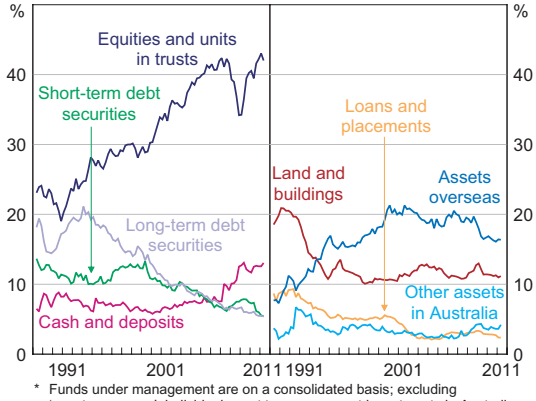
The two largest providers of lenders' mortgage insurance (LMI) in Australia, Genworth and QBE, have reported solid results in the first half of 2011. A key risk for the LMIs is the possibility of increased claims in the event that housing arrears continue to rise and housing prices remain weak. However, these two LMIs are well capitalised and both are rated AA- by S&P. The credit rating of Genworth's Australian operation has been unaffected by S&P's recent ratings downgrade of Genworth's US mortgage insurance operations, which reported a larger-than-expected loss in the June quarter 2011. In confirming Genworth Australia's rating, S&P stated that it had limited links to the troubled US operations, was soundly capitalised with robust reinsurance arrangements, and was subject to strong prudential supervision from APRA.

Managed Funds

Growth in assets held by the domestic funds management industry slowed over the June 2011 half year, with consolidated assets increasing by 4 per cent on an annualised basis in the period compared with a 9 per cent increase in the December 2010 half year (Table 2.3). Superannuation funds accounted for much of the growth in assets over the six months to June 2011. In unconsolidated terms, superannuation assets increased by almost 7 per cent on an annualised basis during the period, and superannuation funds now account for 70 per cent of managed funds' assets.

The slower asset growth in the latest half year was mainly attributable to a decline in the direct and indirect holdings of equities by superannuation funds, which were affected by the volatility in equity markets, particularly in the June quarter 2011. Funds' holdings of cash and deposits increased in the June 2011 half year, although this was partly offset by a decline in holdings of short-term debt securities (Graph 2.23). Reflecting the weaker equity market performance over the June quarter 2011, superannuation funds reported a small net investment loss of around $8 billion in the June quarter, although the overall result for the June 2011 half year was in line with the average over the past decade (Graph 2.24). Net inflows into superannuation funds remained broadly steady.

Graph 2.23
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

Life insurers' unconsolidated assets grew at an annualised rate of nearly 3 per cent in the six months to June 2011. Much of the increase was attributable to the investments of life insurers' superannuation business, which account for around 90 per cent of life insurers' assets. Life insurers reported aggregate profits in the June 2011 half year of $1.5 billion, of which 55 per cent came from

Table 2.3: Assets of Domestic Funds Management Institutions
June 2011

	Level	Share of total	Six-month-ended annualised change	
			Dec 10	June 11
	$billion	Per cent	Per cent	Per cent
Superannuation funds	**1 299**	**70**	**15.7**	**6.6**
of which:				
Equities	377	29	33.9	3.5
Assets overseas	188	14	10.3	11.3
Units in trusts	175	13	25.1	10.3
Deposits	170	13	11.7	15.7
Net equity in life offices	164	13	10.6	-4.0
Land, buildings and equipment	74	6	7.4	10.7
Long-term securities	53	4	–10.1	3.7
Short-term securities	50	4	–8.9	–13.2
Loans and placements	10	1	10.0	–1.5
Other assets in Australia	37	3	–13.8	47.0
Life insurers[(a)]	**235**	**13**	**7.1**	**2.8**
Public unit trusts	**283**	**15**	**0.8**	**–5.6**
of which:				
Listed property trusts	125	44	4.7	–0.9
Unlisted equity trusts	98	35	6.3	–5.5
Listed equity trusts	35	12	–9.3	–17.8
Other trusts	25	9	–18.4	–9.3
Other managed funds[(b)]	**39**	**2**	**–37.7**	**–12.3**
Total (unconsolidated)	**1 856**	**100**	**10.2**	**3.6**
of which:				
Cross investments	406		15.5	1.1
Total (consolidated)	**1 449**		**8.7**	**4.4**

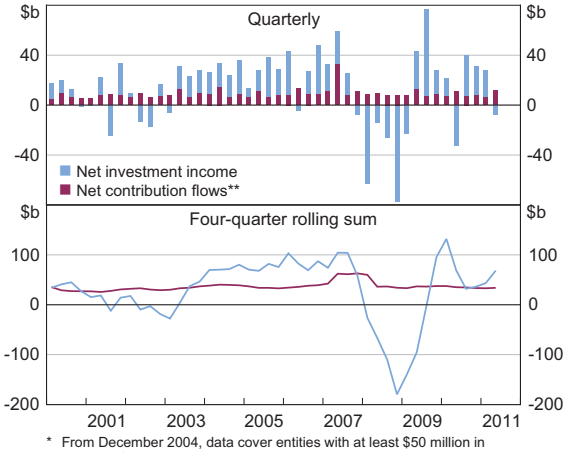
(a) Includes superannuation funds held in statutory funds of life insurers
(b) Cash management trusts, common funds and friendly societies
Sources: ABS; RBA

their superannuation business (Graph 2.25). The net premiums and net policy payments of these superannuation businesses were similar in the June 2011 half year compared with the previous half. The remainder of life insurers' profits were derived from ordinary life insurance business. Profit from this business was broadly flat when compared with the previous half year, with levels of net premiums and net policy payments remaining steady.

Life insurers remain well-capitalised, holding capital around 1.5 times their minimum capital requirements as at June 2011. As noted above, APRA is reviewing life insurers' capital standards as part of its broader review of insurers' capital standards.

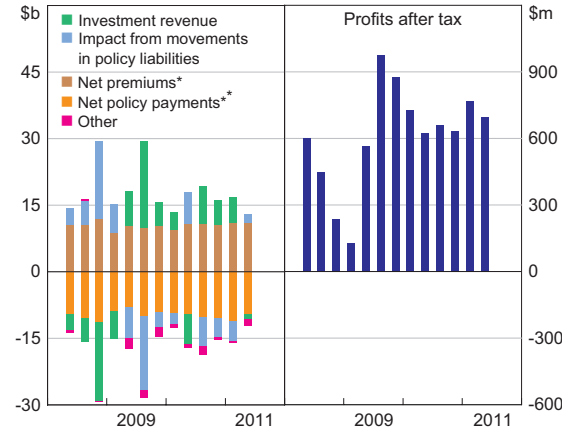
Outside of superannuation funds and life insurers, the majority of managed funds' assets are held in public unit trusts, although their share of the managed funds industry has been falling. Equity trusts experienced falls in their assets over the June half year, reflecting weaker equity markets in the second quarter. Listed property trusts had a small fall of less than 1 per cent in their asset holdings.

Graph 2.24
Superannuation Funds' Financial Performance*



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

Graph 2.25
Life Insurers' Financial Performance



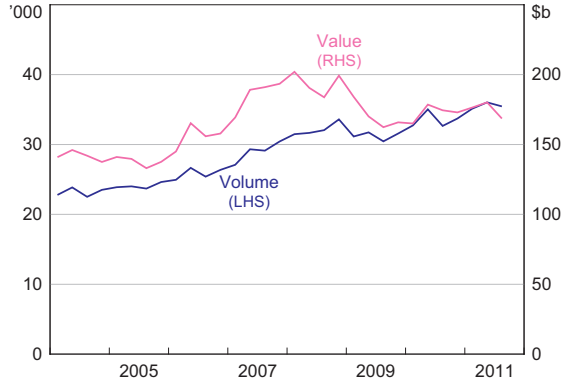
* Sum of net policy revenue, premium-related fees and net policy revenue recognised as a deposit
** Sum of net policy expenses and net policy expenses recognised as a withdrawal
Source: APRA

Market Infrastructure

Over the past six months, Australia's payments system infrastructure continued to perform well. Despite some episodes of unsettled market conditions during the period, the growth in the volume and value of high-value interbank payments and foreign exchange transactions involving the Australian dollar was broadly in line with the trends observed since the crisis. The generally low level of volatility in financial markets over the first half of 2011 was reflected in lower margins held by the central counterparties, although heightened volatility in August saw the central counterparties increase margins.

The number of transactions settled in the Reserve Bank Information and Transfer System (RITS) – where high-value payment transactions are settled on a real-time gross settlement (RTGS) basis – remained at peak levels in the first three quarters of 2011, with around 36 000 transactions settled on average each day; this is above the peak in activity before the onset of the crisis (Graph 2.26). In contrast, the average value of transactions settled in RITS fell slightly to $169 billion per day in the September quarter to date, which is about 17 per cent below the pre-crisis peak. The main impact of unsettled markets has been on values rather than volumes of RTGS activity.

Graph 2.26
RITS Settled Payments*
Daily average

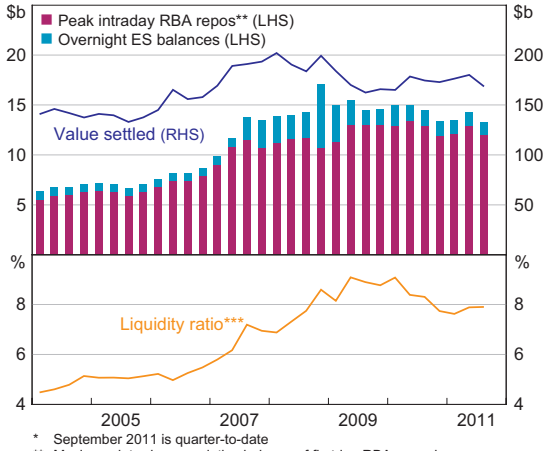


* September 2011 is quarter-to-date
Source: RBA

Transactions in RITS settle across Exchange Settlement (ES) accounts held at the Reserve Bank, with final and irrevocable settlement achieved by the simultaneous crediting and debiting of the ES accounts of banks and other approved institutions. Sufficient liquidity in the form of intraday ES balances is critical to ensuring that the settlement of those transactions can occur, as ES accounts are

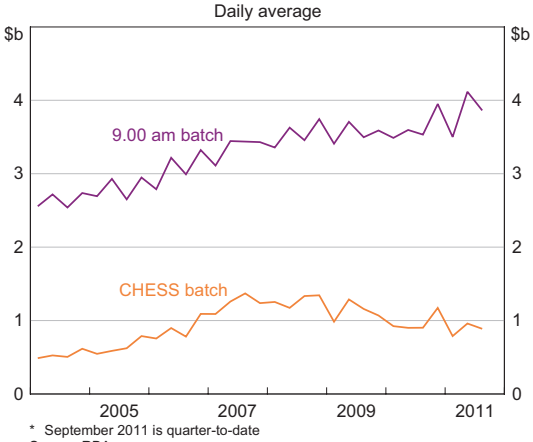
not permitted to overdraw at any time. One way to measure the amount of liquidity available to support settlement is to observe the peak in daily ES balances, calculated as the sum of overnight ES balances and the maximum level of intraday repurchase transactions (repos) undertaken with the Reserve Bank. By this measure, the amount of liquidity to support settlement peaked soon after the collapse of Lehman Brothers in September 2008 (Graph 2.27, top panel). After generally declining following the crisis, peak daily ES balances rose to $14.2 billion in the June quarter 2011, before returning in the September quarter to levels similar to the December quarter 2010. Most of the recent change in intraday ES balances has come through changes in intraday repo activity, with demand for overnight precautionary ES account balances continuing its steady decline from the peak levels seen during the crisis. The liquidity ratio, measured as peak daily liquidity over settled value, approached 8 per cent in the September quarter to date (Graph 2.27, bottom panel). This measure of liquidity remains reasonably high compared with its historical average.

Graph 2.27
RITS Peak Liquidity*
Daily average



* September 2011 is quarter-to-date
** Maximum intraday cumulative balance of first-leg RBA repos less second-leg RBA repos
*** Peak liquidity as share of value settled
Source: RBA

Graph 2.28
RITS Batch Settlement*
Daily average

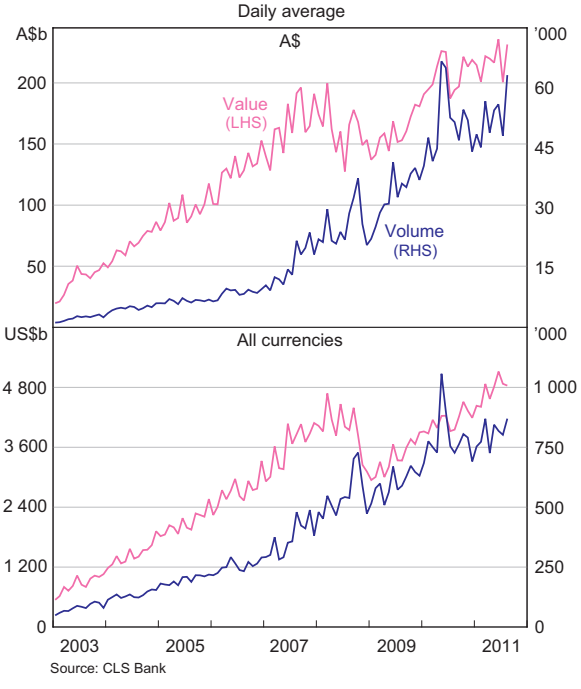


* September 2011 is quarter-to-date
Source: RBA

RITS also settles batches of net interbank obligations. The 9.00 am batch includes the settlement of low-value retail payments, such as cheques, debit and credit card transactions, and direct entry. In the June quarter 2011, the average daily value settled in the 9.00 am batch increased to a new peak of $4.1 billion, up 18 per cent compared with the previous quarter (Graph 2.28). This included the largest daily 9.00 am batch since October 2008, with a settled value of $9.4 billion, on Wednesday, 27 April – the first settlement day after the 5-day Easter/Anzac Day public holiday period. These 9.00 am batch values have remained high in the September quarter. The average daily value settled in the ASX's CHESS (Clearing House Electronic Sub-register System) batch – which settles payment obligations arising from equities transactions – fell in the September quarter to date, after increasing by 22 per cent in the June quarter 2011. The values settled in the CHESS batch remain well below their pre-crisis levels and reflect the 'lumpiness' of capital raising activity, together with fluctuations in equities market turnover.

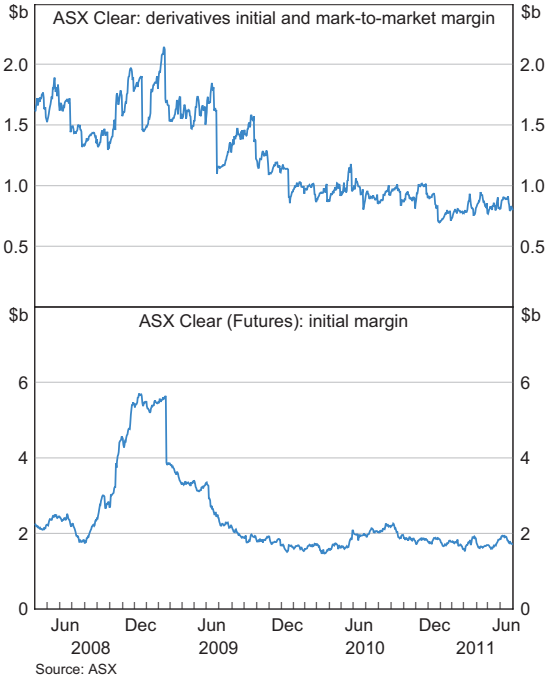
Continuous Linked Settlement (CLS) Bank settles foreign exchange transactions on a payment-versus-payment basis, thereby eliminating foreign exchange settlement risk. It settled an average of $218 billion of foreign exchange transactions

Graph 2.29
CLS Settlement



Source: CLS Bank

Graph 2.30
Margins



Source: ASX

involving the Australian dollar each day in 2011 to August (Graph 2.29, top panel), around $13 billion more than the average settled each day in the second half of 2010. This is in line with the trend of strong growth in the value of settlements across all currencies since the crisis (Graph 2.29, bottom panel).

Two central counterparties, ASX Clear and ASX Clear (Futures), are operated by the Australian Securities Exchange and play a critical role in Australia's financial markets. Through a process known as novation, these entities interpose themselves between trades – effectively becoming the buyer to every seller and seller to every buyer – on Australia's major equities and derivatives markets. While this reduces risk arising from bilateral exposures between participants, it also leads to the concentration of risks within the central counterparties, which they manage through a range of risk controls.

ASX Clear and ASX Clear (Futures) are overseen by the Australian Securities and Investments Commission (ASIC) and the Reserve Bank. ASIC has responsibility for ensuring that central counterparties licensed under the *Corporations Act 2001* meet their obligations under the Act. The Reserve Bank has responsibility for ensuring that licensed central counterparties conduct their affairs in a way that is consistent with financial system stability. To this end, the Reserve Bank conducts an annual assessment of each central counterparty's compliance with the Reserve Bank's *Financial Stability Standard for Central Counterparties*.

A key risk control employed by the central counterparties is the collection of margin on derivatives positions. Despite derivatives trading growing in the first half of 2011 compared with the second half of 2010, the margin held against these positions fell slightly (Graph 2.30). This partly reflected the lower level of volatility in market prices in the period as a whole, even though volatility of equities prices increased following the Japanese earthquake and tsunami in March. The more recent spike in volatility since early August led to increases in the number of intraday margin calls made by the central counterparties and the initial margin rates on many derivatives contracts.

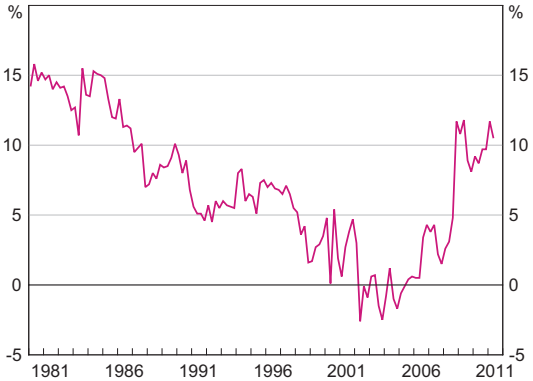
3. Household and Business Balance Sheets

The household sector is continuing to consolidate its financial position. Over the past year, the household saving rate increased further and the debt-to-income ratio declined slightly. Given that household net worth declined in the wake of renewed volatility in global financial markets, the prevailing mood of caution appears unlikely to lift in the near term. While households in aggregate are managing their debt levels well, the mortgage arrears rate drifted up over the first half of the year. However, this mainly relates to loans taken out prior to 2009, when banks' lending standards were weaker; newer loans are performing well despite the increase in interest rates last year. The business sector is also experiencing mixed conditions: the mining and related sectors continue to benefit from the resources boom, while other sectors, including retail, are facing headwinds from subdued domestic household spending and the high exchange rate. Measures of profits and business confidence have therefore diverged between sectors. Having deleveraged considerably, the business sector is in a better financial position than it was several years ago, but its demand for external funding remains weak.

Household Sector

The financial position of the household sector continues to be shaped by a more cautious attitude to spending and borrowing, as evidenced by the considerable increase in the household saving rate (Graph 3.1). After trending up since the mid 2000s, the household saving rate rose further over the past year, reaching 10½ per cent of disposable income in the June quarter. It is now at levels similar to those last seen in the mid 1980s.

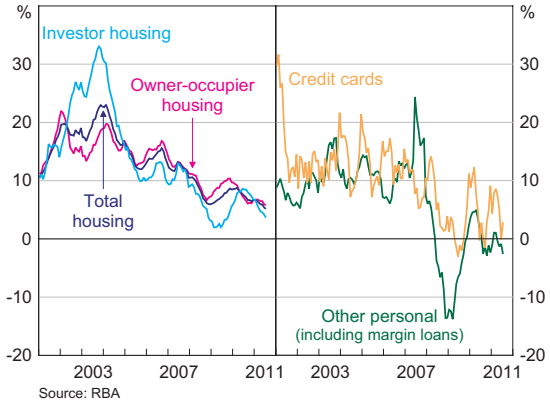
Graph 3.1
Household Saving
Per cent of household disposable income



Source: ABS

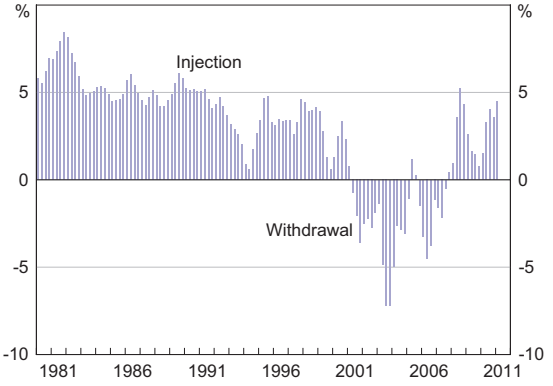
One financial counterpart to the higher saving rate has been a substantial slowdown in the pace of household credit growth. Growth in household credit continued to moderate over the past year, declining to 4.5 per cent in annualised terms over the six months to July. There has been a reduced appetite for most types of debt. Personal credit outstanding declined over the same period, reflecting a recent contraction in credit card debt as well as the ongoing decline in margin lending. The value of outstanding margin debt has more than halved from its peak in late 2007, as volatility in share markets has made equity investments less attractive. Similarly, annualised growth in housing credit eased from 6.7 per cent over the six months to January to 5.2 per cent over the six months to July (Graph 3.2). Growth rates of both owner-occupier and investor housing debt have moderated so far this year. The flow of new borrowing has also moderated, with the value of monthly housing loan approvals

Graph 3.2
Household Debt by Type
Six-month-ended annualised percentage change



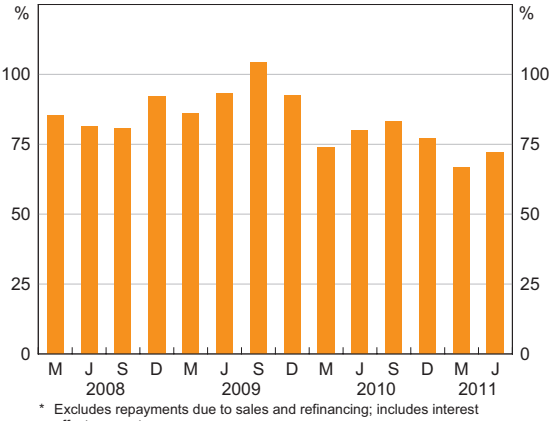
Source: RBA

Graph 3.3
Housing Equity Injection
Per cent of household disposable income, trend*



* Household disposable income excludes unincorporated enterprises and is before interest payments; five-term Henderson trend
Sources: ABS; Australian Treasury; RBA

Graph 3.4
Net Excess Mortgage Repayment Flows*
Per cent of scheduled repayments**



* Excludes repayments due to sales and refinancing; includes interest offset accounts
** Scheduled repayments include interest and principal
Source: APRA

declining by 7 per cent since late 2010. While mortgage refinancing activity has picked up since early 2011, surveys suggest that this is mainly due to households switching to cheaper loans – amid increased competition in the mortgage market – and consolidating debt, rather than taking out larger loans. As debt accumulation has slowed in recent years, the rate of housing equity injection has increased (Graph 3.3).

Contributing to the slower pace of debt accumulation, some households are saving more by choosing to pay down their debt more quickly than required. Net repayments on credit cards have picked up in recent months. Many housing loan borrowers have continued to make substantial excess principal repayments, even as higher interest rates have raised required interest – and thus total – repayments. The average excess repayment is currently equivalent to around three-quarters of the scheduled total (principal plus interest) repayment (Graph 3.4). Consistent with this tendency to pay debt ahead of schedule, surveys have shown that a high share of households consider repaying debt to be the wisest place for savings. Households that make excess repayments on their home loans generally build up buffers that they can draw down in the future if required. This should be regarded as a positive development for the resilience of the sector.

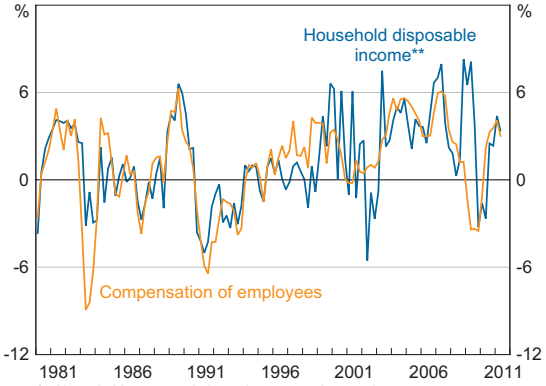
These shifts in saving and borrowing behaviour have in part been enabled by a favourable labour market and solid income growth. The unemployment rate has averaged a little above 5 per cent in recent months after falling from 5.8 per cent in mid 2009. However, forward-looking indicators of labour demand have eased in recent quarters, suggesting only moderate growth in employment in the period ahead. Measured growth in disposable incomes was temporarily boosted by the sharp increase in non-life insurance claims associated with the

natural disasters earlier in the year, but other, ongoing, sources of income have remained strong. For example, real compensation of employees per household rose by 3 per cent over the year to the June quarter, reflecting solid employment and wages growth (Graph 3.5). Growth in gross income therefore outpaced the impact of higher interest payments, such that growth in real disposable income per household (after interest payments) also strengthened, to 3.3 per cent over the year to the June quarter, up from 2.3 per cent over the year to the December 2010 quarter.

Putting the slow rate of borrowing and solid income growth together, the ratio of household debt to annual household disposable income fell modestly from a peak of 158 per cent in mid 2010 to 154 per cent in the June quarter (Graph 3.6). This ratio has now been broadly unchanged since 2006. After rising through 2010, the ratio of household interest payments to disposable income also declined slightly in the first half of the year, to 11.7 per cent. Despite being around 2 percentage points lower than its September quarter 2008 peak, it is still relatively high by historical standards.

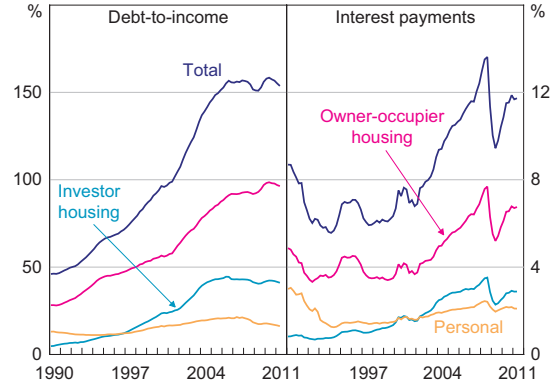
Households might have been motivated to become more cautious in their financial behaviour in part because their net asset position is no longer following its past trend of rapid expansion. Household net worth is estimated to have declined slightly over the first half of 2011, compared with annual average growth of almost 9 per cent over the past decade. A further decline is likely in the September quarter, given that share prices have fallen. The recent weakness has, however, mainly been driven by falls in dwelling prices, which were down about 2 to 2½ per cent on a nationwide basis over the year to the June quarter (Graph 3.7).

Graph 3.5
Household Income*
Real, per household, year-ended percentage change



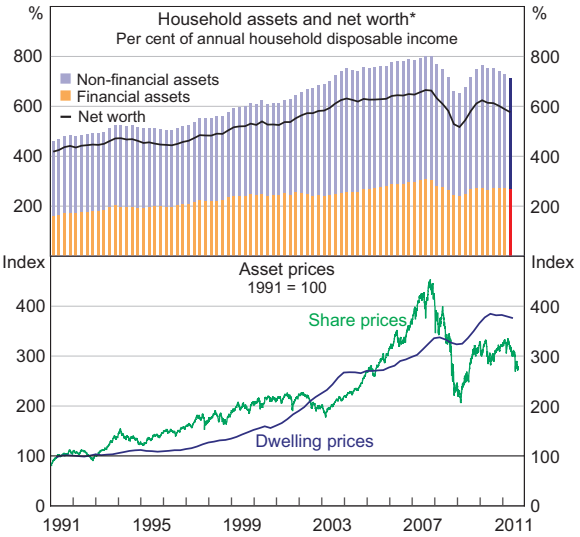
* Household sector excludes unincorporated enterprises
** After interest payments; income level smoothed with a two-quarter moving average between March 2000 and March 2002
Sources: ABS; RBA

Graph 3.6
Household Indebtedness and Interest Payments
Per cent of household disposable income*



* Household disposable income excludes unincorporated enterprises and is before interest payments; debt-to-income uses annual income
Sources: ABS; RBA

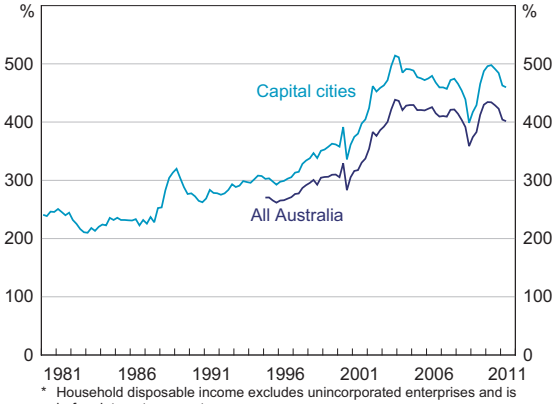
Graph 3.7
Household Assets and Asset Prices



* Includes income and financial assets of unincorporated enterprises and is before interest payments; RBA estimates for June quarter 2011
Sources: ABS; APM; Bloomberg; RBA; REIA

Softness in housing markets has been reasonably broad-based, with dwelling prices falling the most in Perth and Brisbane over the year, while Sydney and Canberra have been fairly resilient. The ratio of dwelling prices to income has declined over the past year to around the average level of the past decade (Graph 3.8). The spread between rental and real bond yields has also widened in recent years.

Graph 3.8
Dwelling Prices
Per cent to average annual household disposable income*

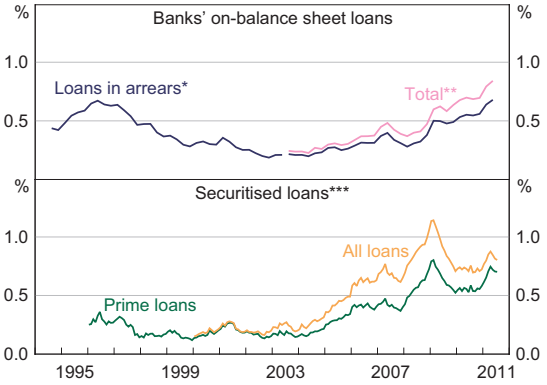


* Household disposable income excludes unincorporated enterprises and is before interest payments
Sources: ABS; APM; RBA; REIA

Growth in household financial assets has also been modest. Over the six months to June, household financial assets are estimated to have expanded by around 4 per cent in annualised terms, compared with average annual growth of about 8½ per cent over the past decade. Continued net inflows, particularly into superannuation and deposits, offset negative valuation effects associated with falls in share prices. Given the volatility in equity markets in recent years and higher returns being offered on deposits, households have become more conservative in their investment preferences, directing a larger share of their discretionary savings to deposits while reducing direct equity investments. This is also consistent with surveys showing an increase over the past few years in the proportion of households nominating bank deposits as the wisest place for their savings and fewer nominating equities and real estate.

Financial stress indicators continue to show that the household sector in aggregate is coping reasonably well with its debt level and higher interest rates, although mortgage arrears rates have increased recently. After broadly levelling out in 2010, mortgage arrears rates resumed their upward drift over the first half of 2011. By loan value, the share of non-performing housing loans on banks' balance sheets increased to 0.8 per cent in June, from 0.7 per cent in December 2010 (Graph 3.9). The upward movement is also evident in the monthly data on securitised housing loans, with the 90+ day prime arrears rate up about 12 basis points over the same period, to 0.7 per cent. However, it appears to have stabilised at these levels more recently.

Graph 3.9
Non-performing Housing Loans
Per cent of outstandings



* Loans that are 90+ days past due but otherwise well secured by collateral
** Includes 'impaired' loans that are in arrears (or are otherwise doubtful) and not well secured by collateral
*** Loans securitised by all lenders, 90+ days past due; excludes self-securitisations
Sources: APRA; Perpetual; RBA; Standard & Poor's

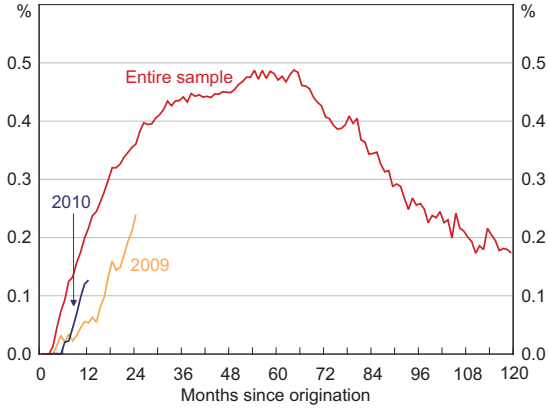
The increase in arrears over the first half of the year likely reflects a combination of factors. Cost of living pressures from higher interest rates and rising utility and petrol prices may have become more important as the pace of expansion in employment slowed in the past year. A sharper increase in the arrears rate on variable-rate than fixed-rate securitised housing loans over the past six months is consistent with this. Higher interest rates and costs of living are also cited as the dominant sources of mortgage repayment stress in household surveys conducted in the first half of 2011.

To a lesser extent, the natural disasters earlier in the year, particularly the Queensland floods, may also be contributing some upward pressure on arrears. A large number of borrowers in affected areas were granted temporary repayment holidays, with at least some of these loans being classified as non-performing. Even so, recent liaison with the major banks indicates that the majority of borrowers exiting hardship relief have been able to resume loan repayments, so this effect on arrears rates is likely to be only temporary.

Comparing the performance of housing loans across age cohorts, it appears that most of the recent increase in the mortgage arrears rate has been due to loans that were taken out prior to 2009. Loans that were extended towards the end of earlier periods of strong housing price growth and weaker lending standards have generally been the worst performing in recent years (see 'Box C: A Closer Look at Housing Loan Arrears'). Housing loans made since 2009, including for many first-home buyers, have been performing better than earlier cohorts, despite the fact that these borrowers are typically facing higher interest rates than at origination (Graph 3.10). This likely reflects an improvement in loan quality due to a tightening in lending standards after 2008. In particular, the share of new low-doc housing loans (where borrowers can provide less evidence of debt-servicing ability than normal) has fallen considerably since 2008 (Graph 3.11). The share of new loans with loan-to-valuation ratios above 90 per cent also fell significantly in recent years, though it has edged up over the past year as competition in the mortgage market has intensified.

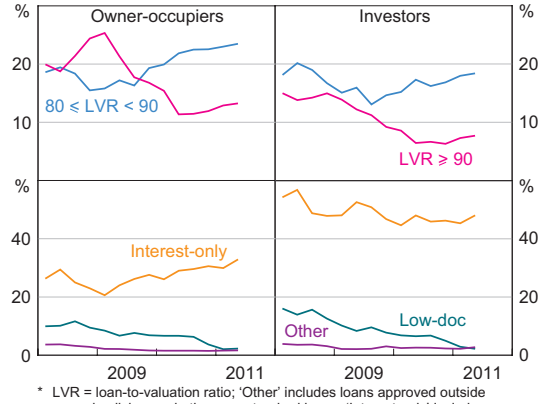
Even though loan performance deteriorated over the first half of the year, the overall mortgage arrears rate in Australia is still low by international standards (Graph 3.12). Looking forward, the experiences of those countries that currently have high arrears rates, as a result of high unemployment or an excessive easing in lending standards in earlier housing price booms, are unlikely to be the model for future outcomes in Australia. First, housing

Graph 3.10
Securitised Housing Loan Arrears by Cohort*
90+ days past due, per cent of outstandings



* Prime loans securitised by all lenders; includes self-securitisations
Sources: Perpetual; RBA

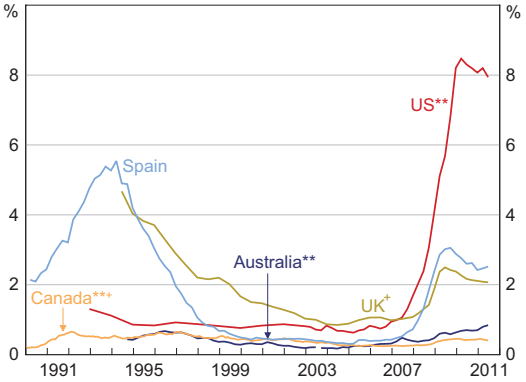
Graph 3.11
Banks' Housing Loan Characteristics*
Share of new loan approvals



* LVR = loan-to-valuation ratio; 'Other' includes loans approved outside normal policies, and other non-standard loans; 'Interest-only' includes mortgages with 100 per cent offset accounts
Source: APRA

prices in Australia did not grow especially rapidly in most parts of the country in the period since 2004, although Queensland and Western Australia were exceptions at various stages. The decline in housing prices recently has been modest compared with the sharp downturns seen in some cases overseas. Second, even before their tightening in 2009, lending standards in Australia had not eased as much as in some other countries. The near absence of sub-prime housing loans in Australia relative to the United States is one prominent example. Australian

Graph 3.12
Non-performing Housing Loans
Per cent of loans*



* Per cent of loans by value; includes 'impaired' loans unless otherwise stated; for Australia, only includes loans 90+ days in arrears prior to September 2003
** Banks only
\+ Per cent of loans by number that are 90+ days in arrears
Sources: APRA; Bank of Spain; Canadian Bankers' Association; Council of Mortgage Lenders; FDIC; RBA

lenders also assess mortgage serviceability at higher interest rates than those prevailing at origination, a practice not always followed overseas. Third, as noted above, a large share of mortgage borrowers in Australia make excess repayments. This increases the resilience of households to shocks, relative to countries where it is less common to do so. As well as providing a cushion against changes in borrowers' financial circumstances, excess repayments increase the distance between the remaining loan balance and a property value that could be lower in the future, making negative equity positions less likely. Finally, the labour market in Australia is in better shape than in many other countries, and its prospects are also more favourable given the macroeconomic outlook.

As for arrears rates, other indicators of financial stress do not suggest that household financial circumstances have deteriorated markedly. Rates of applications for property possession picked up in most regions in the first half of 2011, consistent with the deterioration in loan performance. They remain below earlier peaks except in Western Australia and south-east Queensland, where the rates of applications for property possession are closer to their recent peaks. The nationwide rate of bankruptcies and other personal administrations declined further in the first half of 2011, and is now well below the peak in 2009, though this also tends to be a more lagged indicator of household financial stress.

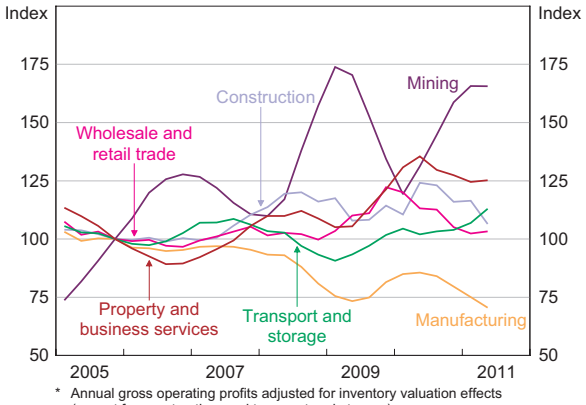
Business Sector

The business sector continues to be affected by conflicting forces, with the resources sector and related industries benefiting from strong foreign demand for Australian commodities, while some other industries are facing challenges from the high level of the exchange rate and relatively subdued domestic household spending. These influences have been reflected in business conditions and profitability during the past year, which have been more moderate outside the mining and related sectors. Overall, though, the business sector has continued to strengthen its financial position.

According to the national accounts, business profits rose by almost 10 per cent over the year to the June quarter in year-average terms, with mining profits increasing by around 35 per cent and non-mining profits declining slightly. The non-mining profits-to-GDP ratio declined from its late 2009 peak and is now slightly below the average of the past decade, while the ratio for the mining sector is well above its long-run average level. Most non-mining industries have seen their profits decline as a share of GDP in the past year, particularly manufacturing and construction (Graph 3.13). Consistent with these trends, firms' perceptions of current conditions and their confidence for the upcoming period have been above average in the mining and related industries, but only around or a little below average in most other industries (Graph 3.14).

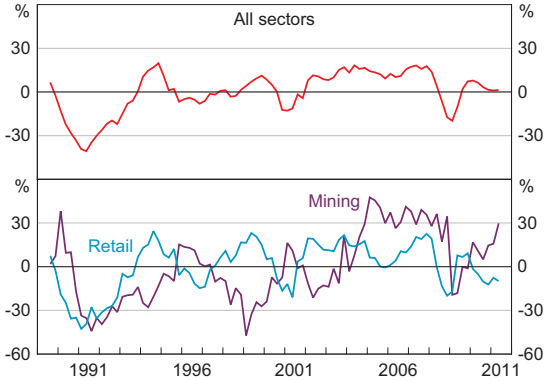
The sectoral divergence has also been evident in announcements during the latest corporate reporting season. On a matched sample basis, listed resources companies reported underlying earnings to be up around 45 per cent in the 2010/11 financial year compared with the previous financial year, even though some of them suffered falls in their June

Graph 3.13
Industry Profitability*
Per cent of GDP, December 2005 = 100



* Annual gross operating profits adjusted for inventory valuation effects (except for construction, and transport and storage)
Sources: ABS; RBA

Graph 3.14
Business Conditions Surveys
Net balance, deviation from long-run average

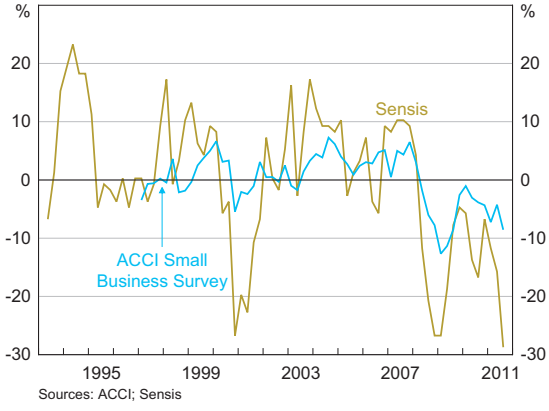


Sources: NAB; RBA

half-year earnings because of adverse weather earlier in the year. In contrast, underlying earnings declined by 5 per cent in the 2010/11 financial year for other listed non-financial companies. Although analysts have revised down earnings forecasts across most sectors since March, they continue to predict strong growth in resources companies' profits.

Smaller businesses have experienced rising profits over the past year, but to a lesser extent than larger businesses. For example, over the year to the June quarter, the national accounts measure of profits of unincorporated enterprises increased by 7 per cent in year-average terms, compared with 11 per cent for the profits of incorporated businesses. Partial credit bureau data suggest that profitability in the unlisted (generally smaller) business sector has improved since 2009 but remains below pre-crisis levels, especially for the smallest firms. The median after-tax return on assets among the limited sample of firms that have already reported 2011 results was 4.7 per cent, compared with a pre-2009 average of about 6.7 per cent. While the share of all unlisted firms making losses has returned to its pre-crisis average, the share of smaller unlisted firms making losses remains above average. Around 40 per cent of firms with assets under $1 million reported losses in 2010 and 2011, compared with an average of 25 per cent over 2006 to 2008. Survey evidence indicates that small business profitability remains below average and industry liaison also suggests that stress among this segment has been increasing (Graph 3.15).

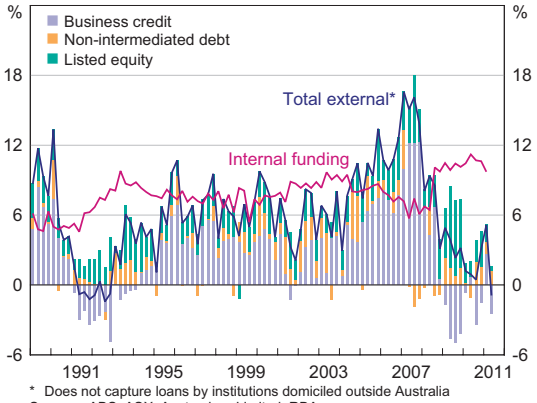
Graph 3.15
Small Business Profitability
Deviations from long-run average



Sources: ACCI; Sensis

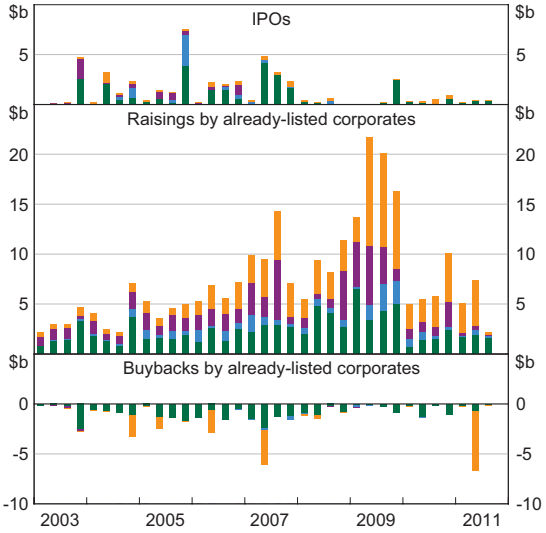
The business sector has been able to finance a larger share of its investment through internal funding in recent years, largely because that investment has been concentrated in sectors such as mining, where profitability has increased the most. Internal funding of non-financial corporates fell slightly in the March quarter, but was still close to its average of the past few years of 10 per cent of GDP (Graph 3.16). This compares with a long-run average of about 8 per cent of GDP.

Graph 3.16
Business Funding
Per cent of GDP, quarterly



* Does not capture loans by institutions domiciled outside Australia
Sources: ABS; ASX; Austraclear Limited; RBA

Graph 3.17
Listed Non-financial Corporates' Equity Raisings*



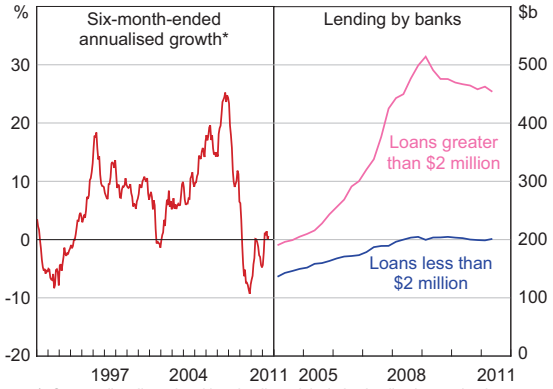
* Excludes privatisations and hybrid conversions, which are very small; September quarter 2011 includes July and August only
Sources: ASX; RBA

In contrast to internal funding, businesses' external funding has been subdued in recent years. Looking through the quarterly volatility, external funding has averaged around 2½ per cent of GDP since 2009, below the long-run average of about 6 per cent. The switch from debt to equity funding evident during the crisis, when many firms sought to reduce their leverage, appears to have run its course. Listed non-financial companies raised about $16 billion of equity over the eight months to August, slightly above the corresponding period in 2010 (Graph 3.17). This was partly offset by buybacks, including BHP's $6 billion purchase of domestically listed shares. Consequently, net equity raisings over the same period were only about $9 billion, which was below the long-run average. Resources companies accounted for much of the equity issuance in the past few years, while issuance by companies in the real estate and infrastructure sectors remained low. Reflecting the general weakness in share prices, there have been relatively few initial public offerings during the past few years.

Business debt funding remains subdued: while non-intermediated debt issuance has been robust since mid 2010, this has largely been offset by a contraction in intermediated business credit. Corporate bond issuance in the year to August was $31 billion, up from $18 billion in the previous year. Firms across a number of sectors have taken advantage of strong offshore demand for Australian debt to increase their issuance. Spreads between corporate bond yields and yields on Commonwealth Government securities have increased over the past few months, but generally to a lesser extent than comparable spreads in the United States and Europe, and remain well below the peaks in early 2009.

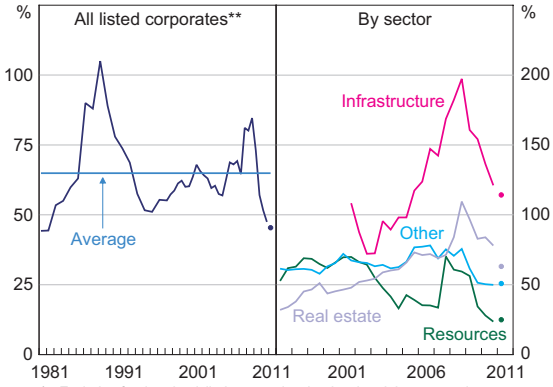
After contracting over much of 2009 and 2010, business credit remains weak. Growth turned positive in the early part of this year, but this was followed by further declines in recent months, such that the level of business credit rose at an annualised rate of only 0.6 per cent over the six months to July (Graph 3.18). The weakness has been concentrated in lending to larger firms. Loans larger than $2 million account for almost all of the decline in bank business credit since the end of 2008, and lending to incorporated businesses has fallen by 11½ per cent over the same period; by contrast, lending to smaller, unincorporated businesses expanded by about 7 per cent.

Graph 3.18
Lending to Businesses



* Seasonally adjusted and break adjusted; includes lending by non-bank financial institutions and securitised loans, but excludes lending to non-residents
Sources: APRA; RBA

Graph 3.19
Listed Corporates' Gearing*



* Excludes foreign-domiciled companies; book value debt over equity; latest observation includes only companies that have reported to June 2011
** Data from 1997 include real estate companies
Sources: ABS; Bloomberg; Morningstar; RBA; Statex; Thomson Reuters

Smaller businesses typically rely more on bank funding because they cannot obtain funding from capital markets. It is therefore not surprising that measures of lending to this group have held up better than lending to larger businesses in recent years. One driver of the difference more recently is that some larger and listed businesses took advantage of favourable conditions to issue debt in wholesale markets, particularly offshore. But the weakness in intermediated borrowing by listed companies, and therefore in overall business credit, was in large part a response to the pressures those firms faced to deleverage, both during the crisis and since. Many of them sought to reduce leverage by replacing debt with equity, sometimes under pressure from their creditors. Surveys point to a reduction since 2009 in the share of firms reporting difficulty obtaining finance. While liaison also indicates that the availability of bank finance has improved over the past year for many firms, credit conditions remain tighter than prior to the crisis.

Listed corporates' gearing remains at low levels not seen since the early 1980s. Book value gearing of listed non-financial companies was around 45 per cent at June 2011, down from a pre-crisis peak of about 85 per cent and below the long-run average of 65 per cent (Graph 3.19). The restructuring of Centro Properties Group, together with continued deleveraging and stable or slightly higher asset valuations at other firms, sharply lowered the gearing of the listed real estate sector over the first half of 2011. Likewise, the restructure of Alinta Energy lowered the gearing of infrastructure firms, despite higher debt levels at a number of other companies in this sector. Debt-funded acquisitions and share buybacks by a few large resources companies, together with higher debt levels at some large industrial and media firms, contributed to a slight rise in gearing across other sectors over the six months to June.

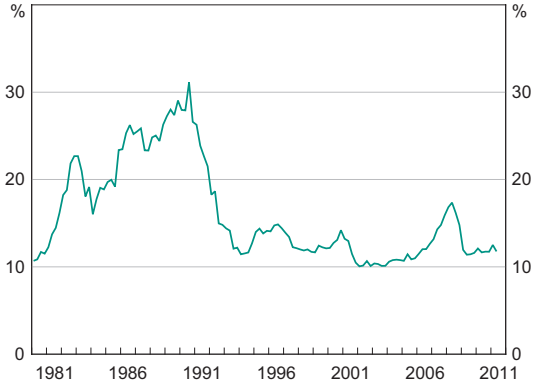
Partial credit bureau data suggest the unlisted business sector has continued to deleverage. Median gearing was 35 per cent based on the 2011 sample of firms, down from 38 per cent in the 2010 sample. As has been the case for a few years, the fall was mostly due to reductions in gearing by the most highly leveraged firms; this pattern could be interpreted as reducing risk in the business sector more than proportionately to the decline in median gearing.

Firms have also strengthened their financial positions by increasing their cash holdings. Year-ended growth in business deposits at banks has recently been around 12 per cent, up from 5 per cent in mid 2010. While listed resources companies reduced their cash holdings over the first half of 2011, these holdings have still grown considerably over recent years due to strong profitability. Liquidity

ratios have also drifted up modestly among other listed and unlisted non-financial companies.

As the business sector has deleveraged, the ratio of its interest payments on intermediated debt to profits has remained below its long-run average level despite the increases in interest rates in the past few years. This ratio declined to about 12 per cent in the June quarter, well below the recent peak of 17 per cent in 2008 (Graph 3.20). Even so, interest-servicing ratios vary widely across different sectors, being above average in sectors such as property where gearing ratios are still relatively high, and well below average in the mining sector.

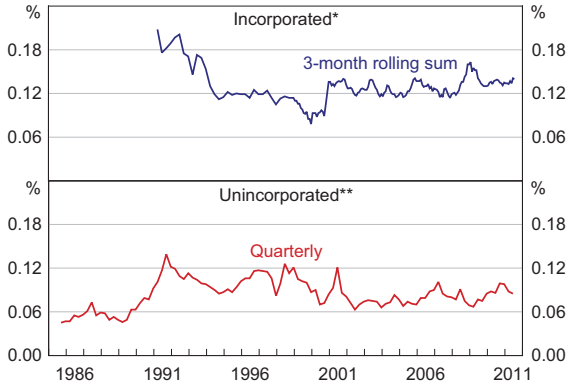
Graph 3.20
Business Interest Payments*
Per cent of profits



* Interest on intermediated debt from Australian-domiciled financial institutions
Sources: ABS; RBA

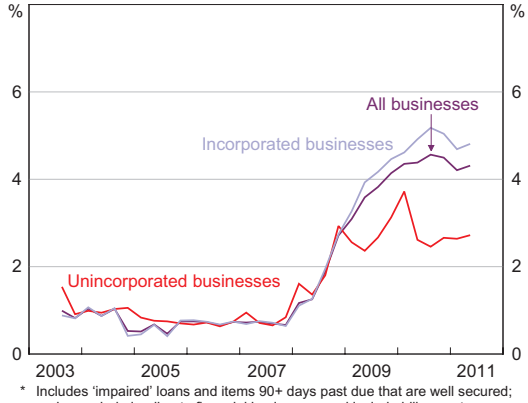
The rate at which incorporated businesses are entering external administration has been relatively stable over recent years, despite a pick-up in June and July (Graph 3.21). Queensland and New South Wales continue to have above-average rates of corporate failure. In contrast, after rising over the past couple of years, the failure rate for unincorporated businesses has moderated since late 2010. As discussed in 'The Australian Financial System' chapter, the share of banks' business loans that is non-performing increased slightly in the June quarter, but remains below the peak reached in September 2010 (Graph 3.22). The non-performance rate is still higher for loans to incorporated businesses than to unincorporated businesses.

Graph 3.21
Business Failures
Per cent of businesses in each sector



* Companies entering external administration, pre-1999 data are quarterly
** Business bankruptcies
Sources: ABS; ASIC; ITSA; RBA

Graph 3.22
Banks' Non-performing Business Assets*
Domestic books, per cent of outstandings by type



* Includes 'impaired' loans and items 90+ days past due that are well secured; series exclude lending to financial businesses and include bill acceptances and debt securities
Sources: APRA; RBA

Commercial Property

Loans for commercial property acquisition and development are the largest component of banks' business lending in Australia, at about one-third. While there has been an improvement recently, these exposures continue to account for about one-half of banks' impaired business loans. In June, around 5.7 per cent of banks' domestic commercial property exposures were classified as impaired, down from a peak of 6.2 per cent in September 2010. Much of the recent improvement has been due to banks selling a few large bad debts.

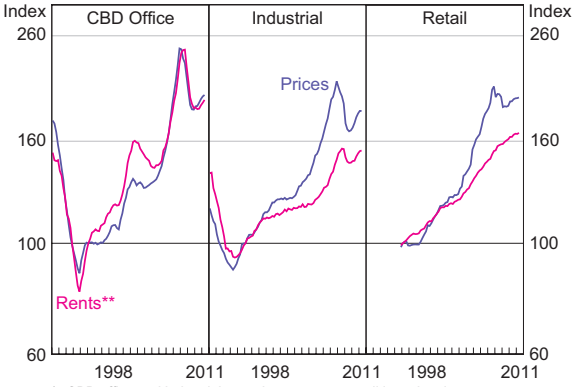
After a period of rising vacancy rates and falling property values and rents, conditions in the commercial property sector have generally improved over the past year. CBD office vacancy rates have edged down in most cities since 2009, particularly in Perth and Brisbane. Consistent with this, office property values and rents have recovered somewhat, though both remain around 20 per cent lower than their recent peaks on a national basis (Graph 3.23). Rents and property values have also increased in the industrial and retail property markets over the past year.

Despite the improvement in conditions overall, commercial property construction activity remains weak. Commercial building work done has continued to moderate as a share of GDP and remains around one-quarter below its long-run average. However, industry liaison points to considerable activity in the Melbourne high-rise residential market. While these projects typically meet appropriate lending standards with strong pre-sales and sufficient equity, some rely heavily on overseas purchasers, a source of demand that might not necessarily be available in the longer term.

The broader weakness in construction activity in part reflects ongoing tightness in lending conditions. While larger developers have good access to wholesale debt markets, industry liaison indicates that access to intermediated finance for small- to medium-sized developers is still quite tight, with lenders requiring stricter collateral and covenant conditions and higher pre-commitment/pre-sale ratios. Foreign-owned and smaller Australian-owned banks continued to reduce their exposures to the domestic commercial property market over the year to June, while the major banks' exposures were relatively steady (Graph 3.24). Non-bank forms of finance also remain constrained, with very little issuance of commercial mortgage-backed securities since the crisis and mortgage trusts' funds under management remaining low. The major banks are now estimated to account for about 65 per cent of all commercial property debt financing in Australia, up from nearly 48 per cent in 2006, due to the larger declines in debt funding from other sources in recent years.

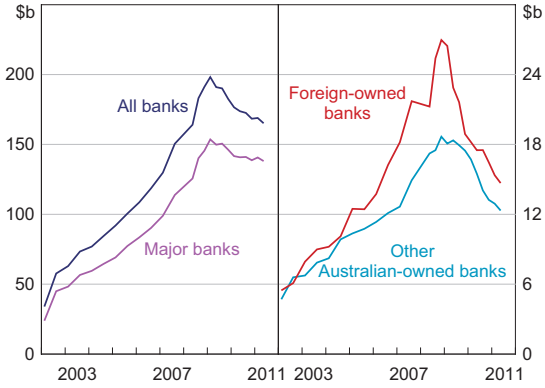
ASX-listed real estate investment trusts (A-REITs) have come closer to completing their targeted balance sheet restructuring and have therefore slowed their equity raisings since 2009. Net equity raisings during the first eight months of 2011 amounted to $0.4 billion, down from $1.4 billion over the same period last year, and well below the pre-crisis average (Graph 3.25). The aggregate debt-to-equity ratio of A-REITs has fallen from 110 per cent in December 2008

Graph 3.23
Commercial Property*
March 1995 = 100, log scale



* CBD office and industrial are prime property, retail is regional property
** CBD office is effective rents, industrial and retail are face rents
Sources: Jones Lang LaSalle; Property Council of Australia; RBA

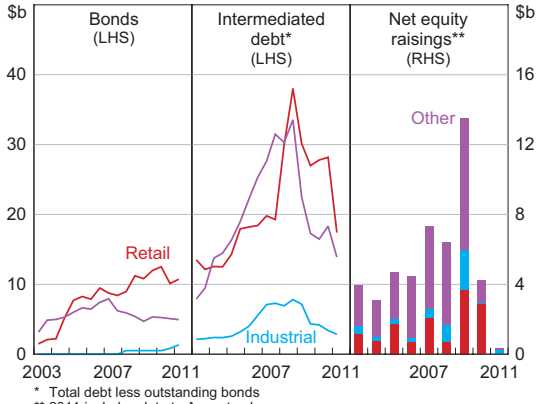
Graph 3.24
Banks' Commercial Property Exposures*



* Consolidated Australian operations; sample of 26 banks
Sources: APRA; RBA

to around 60 per cent as at June 2011. Their profitability has recovered over recent periods, but remains below the high levels seen prior to the crisis when property price appreciation was a contributing factor. Even though they have improved their financial position and profitability, A-REITs' shares trade at lower price-to-book ratios than prior to the crisis.

Graph 3.25
A-REITs' Funding



* Total debt less outstanding bonds
** 2011 includes data to August only
Sources: ASX; Morningstar; RBA

Box C

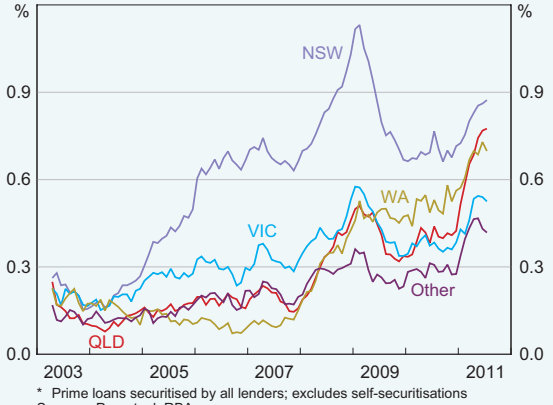
A Closer Look at Housing Loan Arrears

Data on securitised housing loans and liaison with lenders indicate that housing loan arrears rates have recently risen in all the mainland states, especially in Queensland (Graph C1). Some of the deterioration in Queensland reflects the temporary effect of recent natural disasters. But the arrears rate there had already begun to rise before the floods occurred, consistent with Queensland's softer property market and above-average unemployment rate.

Data on the performance of loans by age cohort and state show that arrears rates are highest amongst loans originated towards the end of periods of strong housing price growth and weaker lending standards. For New South Wales, the worst-performing loans are those originated in 2004 and 2005, while for Queensland and Western Australia, loans originated between 2006 and 2008 have tended to perform worst (Graph C2). Many of these loans, particularly those in Queensland and Western Australia, were originated towards the end of periods of rapid housing price growth, which were followed by falls in prices. With prices no longer rising, borrowers from these periods cannot sell their property as easily if they get into payment difficulty, particularly if they are already in negative equity. This may help explain the recent increase in the longer-duration (180+ days) securitised mortgage arrears rate.

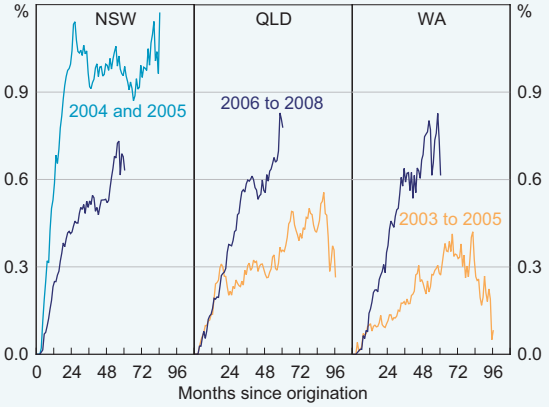
Strong housing price growth in earlier periods may have contributed to a weakening in lending standards, if perceived risk was reduced by expectations of further price growth. These periods tend to be associated with an increase in market share for non-traditional lenders or smaller lenders, and an expansion of riskier products such as low-doc housing loans. In western Sydney between 2004 and 2006, the expansion of mortgage broking allowed newer lenders to compete for market share (see p 47 of the September 2008 *Financial Stability Review* for a discussion of this episode). Many of the loans from this period are still performing relatively

Graph C1
Securitised Housing Loan Arrears by State*
90+ days past due, per cent of outstandings



* Prime loans securitised by all lenders; excludes self-securitisations
Sources: Perpetual; RBA

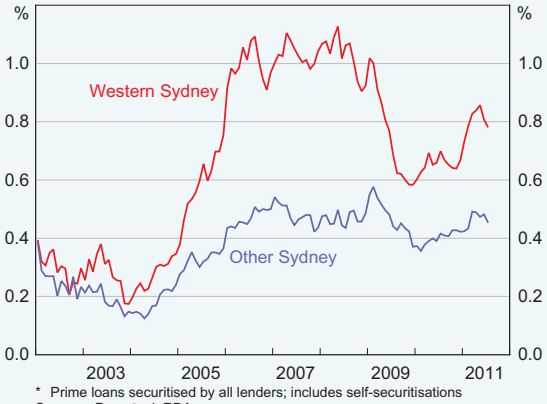
Graph C2
Securitised Housing Loan Arrears by Cohort*
90+ days past due, per cent of outstandings



* Prime loans securitised by all lenders; includes self-securitisations
Sources: Perpetual; RBA

poorly, despite now having largely aged beyond the normal peak arrears time of three to five years (Graph C3).

Graph C3
Securitised Housing Loan Arrears by Region*
90+ days past due, per cent of outstandings

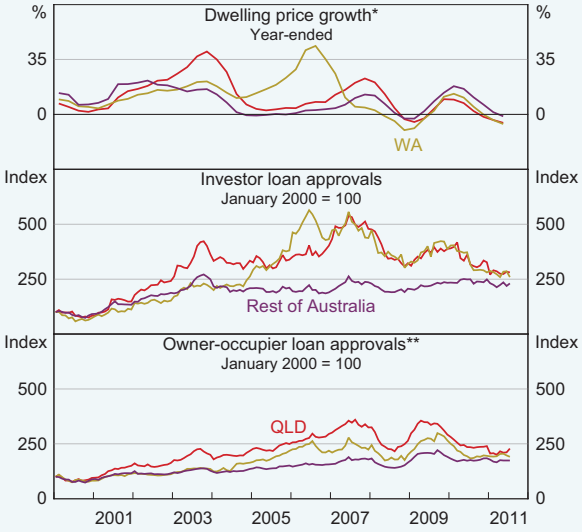


* Prime loans securitised by all lenders; includes self-securitisations
Sources: Perpetual; RBA

During the periods of strong housing price growth in Queensland and Western Australia, investor activity increased significantly more than owner-occupier activity (Graph C4). Between 2000 and 2007, the value of investor loan approvals grew around fivefold in these two states, whereas owner-occupier approvals increased around threefold. Recent softness in housing prices has been associated with sharper falls in investor approvals relative to owner-occupier approvals. This procyclicality in lending may have amplified cyclical movements in prices, raising arrears rates in aggregate.

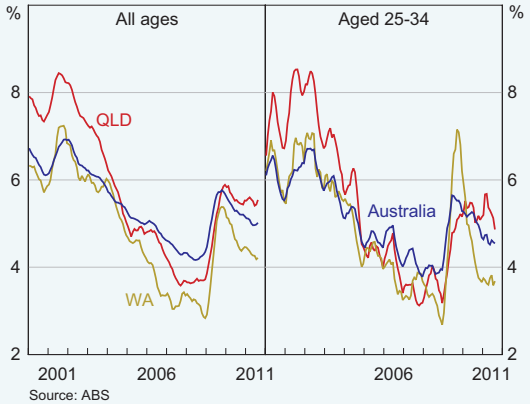
Labour market conditions have also contributed to the recent increase in arrears rates in Queensland and Western Australia. Unemployment increased more sharply in Western Australia in 2009 than in the rest of Australia, particularly for younger households, which are less likely to have accumulated as much savings or equity in their homes relative to other households (Graph C5). Although unemployment there has since fallen, some households may have been unable to make up any missed mortgage payments, even if they are now able to make their current monthly payments, and they therefore may remain in arrears. Unemployment in Queensland has been more persistent than in the rest of Australia, suggesting that some households in this state have faced more

Graph C4
Dwelling Prices and Loan Approvals



* Capital cities only; 'Rest of Australia' excludes units in Darwin, Canberra and Hobart, and houses in Hobart prior to 2003
** Excludes refinancing
Sources: ABS; APM; RBA

Graph C5
Unemployment Rates
Six-month moving average



Source: ABS

prolonged income pressures than national average data imply.

Despite the increase over the first half of 2011, the overall mortgage arrears rate in Australia is still low by international standards, and the bulk of housing loans in arrears are well collateralised. Moreover, as discussed in the 'Household and Business Balance Sheets' chapter, there are a number of reasons why mortgage arrears are unlikely to rise as much as they have in some other countries. Not least is the more favourable macroeconomic environment in Australia.

4. Developments in the Financial System Architecture

Now that the reforms to global bank capital and liquidity standards, known as Basel III, have been finalised, recent efforts by a number of international regulatory bodies have focused on developing a policy framework for systemically important financial institutions (SIFIs), particularly those that are systemically important from a global perspective (so-called G-SIFIs). In July, the Basel Committee on Banking Supervision (BCBS) released a consultation paper on its proposed methodology for identifying a set of globally systemic banks (G-SIBs), with the view that these institutions should be required to have higher capital than the Basel III minimum, given the greater cost their failure would likely impose on the global financial system. At the same time, the Financial Stability Board (FSB) released a consultation paper on measures to improve resolution regimes for all SIFIs. The FSB's aim is to enhance the capacity of authorities to resolve distressed SIFIs without disrupting the wider financial system or exposing taxpayers to losses. These two initiatives are part of the overall policy response by the G-20 and international regulatory bodies to address the 'too big to fail' problem.

There has also been progress over the past six months in the work being guided by the FSB on: reforming over-the-counter (OTC) derivatives markets; developing policy frameworks for shadow banking activities; and, to a lesser extent, developing macroprudential policy frameworks. Domestically, the Australian Prudential Regulation Authority (APRA) has recently issued a consultation paper on the implementation of the Basel III capital reforms in Australia and is proposing that authorised deposit-taking institutions (ADIs) meet a number of the main measures two or three years earlier than required under Basel III. The Government has recently announced changes to the Financial Claims Scheme (FCS), in particular regarding the size of the deposit guarantee cap. The key changes were informed by a review conducted by the Council of Financial Regulators (CFR). The Government has continued to develop a policy framework and legislative changes that will enable ADIs to issue covered bonds in Australia. These and other items on the financial regulatory agenda are outlined below.

The International Regulatory Agenda and Australia

Systemically important financial institutions (SIFIs)

The BCBS' consultation paper 'Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement' sets out its proposed methodology for identifying and ranking G-SIBs, and for determining the size of, and instruments to be used for, the additional loss absorbency (capital) that those banks will be required to hold (above the new Basel III minimum). The BCBS' proposals were developed in close co-operation with the FSB and, along with the resolution measures proposed by the FSB, seek to deal with the cross-border negative externalities created by G-SIBs. With these proposals, the BCBS aims to reduce the probability of G-SIBs failing by enhancing their capital positions. To support this aim, it is developing an international standard to

ensure that this additional capital requirement is applied consistently across countries in which G-SIBs are headquartered.

The BCBS is proposing that G-SIBs be required to hold additional common equity Tier 1 capital ranging from 1 to 2.5 per cent of their risk-weighted assets, depending on the degree of a bank's systemic importance. An additional 1 per cent capital surcharge (for a total of 3.5 per cent) would be applied as a disincentive to any G-SIB that became noticeably more important to the system than the currently highest-ranked G-SIB. It is planned that these higher capital requirements will be introduced in parallel with the Basel III capital conservation and counter-cyclical buffers – that is, starting on 1 January 2016 and becoming fully effective on 1 January 2019. The FSB and several other international bodies are currently undertaking an assessment of the macroeconomic impact of the additional capital requirement; preliminary results indicate that a 1 percentage point increase in capital applied to G-SIBs would dampen growth only very marginally over either a four- or eight-year implementation period.

The BCBS' proposed assessment methodology for G-SIBs is an indicator-based approach comprising five components: size, global (cross-jurisdictional) activity, interconnectedness, substitutability and complexity. To these indicators is added a supervisory judgement overlay, which uses ancillary quantitative indicators as well as qualitative information. Based on end 2009 data, applying the assessment methodology together with the supervisory judgement overlay, the BCBS identified and ranked 28 G-SIBs. This number is likely to evolve over time as banks change their behaviour in response to the incentives provided by the framework, or as new globally systemic banks are identified (for example, from emerging markets). The BCBS has committed to addressing certain data quality issues and to re-running the assessment methodology using updated data well in advance of the implementation date. Several Australian-owned banks were included in the initial list of 73 banks from 17 BCBS member countries that were assessed using the indicator approach, and from which the 28 G-SIBs were identified. The sample of 73 banks will be reviewed periodically, while the assessment methodology itself will be reviewed every three to five years in order to capture banking sector developments and any improvements in the methods for measuring systemic risk. The Reserve Bank of Australia (RBA) and other CFR agencies will continue to contribute to the BCBS' work as it finalises these policies, taking into account the public feedback globally on its consultation paper.

As part of a workstream on reducing information gaps revealed by the global financial crisis, the FSB is also developing a draft reporting template for large global banks. It is intended that this will cover data relating to the above indicators of systemic importance, as well as data capturing measures of systemic risk. The template will be subject to a consultation process to provide additional information on the costs and benefits of alternative data collection options, as well as on the legal and confidentiality aspects of data collection and sharing. This will guide the FSB's decision on the final form and implementation of the data template. The RBA is participating in the development of this template.

In addition to banks, the G-SIFI policy framework will cover insurers. The International Association of Insurance Supervisors (IAIS) is developing a provisional methodology and set of indicators for assessing the global systemic importance of insurers, as input to the initial determination by the FSB and national authorities of G-SIFIs. The indicators are likely to be similar to those used to identify G-SIBs (such as size, global activity and interconnectedness), but also contain certain indicators specific to the insurance sector and may have a different emphasis. A progress report by the IAIS on this methodology was reviewed by the FSB in July. The IAIS has commenced work on collecting data to see how the methodology would apply in practice.

A key feature of the FSB's work on SIFIs has been a distinction between institutions that are systemically important in a global context and those that are important only in a domestic context (so-called D-SIFIs). To date, the focus has been on identifying and developing policies for G-SIFIs. This priority has been appropriate given the concern that the failure of one of these institutions would likely cause significant dislocation in the global financial system and adverse economic consequences across a range of countries. Both the FSB and the G-20 have stated their intention that, once the policy framework for G-SIFIs is agreed, attention will turn to policies relevant for D-SIFIs.

The FSB's consultation paper 'Effective Resolution of Systemically Important Financial Institutions' presents a far-reaching plan to improve resolution regimes, thereby improving the capacity of authorities to resolve failing SIFIs. This is motivated by the experience during the crisis which showed that many national resolution regimes could not effectively manage the failure of a large institution in an orderly manner.

The FSB's proposed recommendations comprise four broad components:

- strengthening of national resolution regimes by giving a designated resolution authority a broad range of powers and tools to resolve a financial institution that is no longer viable and including these in a new international standard;
- introducing cross-border co-operation arrangements, to enable resolution authorities to act collectively to resolve specific cross-border institutions in a more orderly and less costly way;
- improving resolution planning by firms and authorities based on *ex-ante* resolvability assessments that should inform the preparation of 'recovery and resolution plans'; and
- removing obstacles to resolution arising from complex firm structures and business practices, fragmented information systems, intra-group transactions, reliance on service providers and the provision of global payment services.

Australia will continue to engage with international bodies in reviewing developments in these areas. In particular, the RBA, in conjunction with the other CFR agencies, will review Australia's response to emerging international views about the need for standards to be developed in these areas.

Supervisory intensity and effectiveness

The FSB is continuing to co-ordinate efforts to enhance supervisory intensity and effectiveness (SIE) across both the banking and insurance sectors. The FSB recently reviewed the progress being made by national authorities to address SIE, including their self-assessments against the Basel Core Principles for Effective Banking Supervision (BCPs) covering mandates, powers, resources and independence of supervisory agencies. The FSB also considered the changes national authorities are making to improve their supervisory methods based on a survey by the BCBS of its members.

APRA undertook the self-assessment, and concluded that the Australian legislative framework provides APRA with clear responsibility for prudential supervision of banks and banking groups and with sufficient independence, powers and flexibility to undertake this supervision in an effective manner. In relation to insurers, APRA is required to undertake a self-assessment against the IAIS Insurance Core Principles and Methodology by March 2012.

By the end of 2011 the FSB will review whether further steps should be taken to implement or complement the recommendations for enhanced supervision set out in its November 2010 report on SIE (which was discussed in the March 2011 *Review*). One of these recommendations related to improving supervisory standards to reflect the complexity of financial institutions and the system more generally. The relevant standard setters are undertaking reviews of their core principles and will address the SIE recommendations as part of that process. The BCBS intends to issue a paper for consultation on revised BCPs in December 2011; the IAIS is also expected to release its revised Insurance Core Principles later this year.

Implementation of Basel III capital and liquidity reforms

As discussed in recent *Reviews*, the BCBS has issued new standards relating to global bank capital and liquidity. These changes set out internationally agreed minimum requirements for higher and better-quality capital for banks and other deposit-taking institutions, better risk coverage and a new (non-risk-based) leverage ratio. It also includes measures to promote the build-up of capital that can be drawn down in periods of stress. On the liquidity side, the proposals will involve major changes to banks' liquidity risk management policies, in particular introducing internationally agreed minimum quantitative requirements for a bank's short-term and long-term liquidity risk management.

The work on Basel III has now turned to the implementation of the standards, which according to the BCBS' timetable will occur progressively over an extended period starting from 2013 and will mainly involve actions by national authorities. For example, the new minimum capital requirements are not required to be fully implemented until 1 January 2015 (or until 2019 for the capital conservation buffer). Further, the new liquidity requirements, the liquidity coverage ratio and the net stable funding ratio, are not scheduled to come into effect until 1 January 2015 and 1 January 2018, respectively. Despite this extended phase-in period, countries have commenced announcing their plans for implementing Basel III.

APRA has indicated that, as a member of the BCBS, it fully supports the Basel III framework and has recently issued a consultation paper on the implementation of the Basel III capital reforms in Australia. APRA considers that ADIs are well placed to meet the new global minimum capital requirements and will be able to do so without the need for a lengthy phase-in period. Accordingly, APRA is proposing that ADIs meet a number of the main measures two or three years earlier than required under the Basel III rules (Table 4.1). In addition, APRA is not proposing to make use of the five-year phase-in allowed for the changed treatment of deductions from common equity Tier 1 (CET1) capital: APRA is proposing to require deductions to be applied fully from 1 January 2013. APRA intends to adopt the Basel III timing in implementing the other main measures, that is: the phasing out of instruments that no longer qualify as Tier 1 and Tier 2 instruments; the introduction of the leverage ratio; and the introduction of the counter-cyclical capital buffer. APRA has also been working closely with the Reserve Bank on the details of the RBA's committed liquidity facility, and is preparing a consultation paper on the implementation of the Basel III liquidity reforms in Australia that is expected to be released in coming months.

Table 4.1: Transition to Basel III Capital Requirements in Australia

At 1 January	2013 per cent of risk-weighted assets		2016 per cent of risk-weighted assets	
	Basel III	APRA	Basel III	APRA
Minimum CET1	3.5[(a)]	4.5	4.5	4.5
Conservation buffer	–	–	0.625[(b)]	2.5
Minimum Tier 1	4.5[(a)]	6.0	6.0	6.0
Minimum total capital + Conservation buffer	8.0	8.0	8.625[(b)]	10.5

(a) Fully phased in on 1 January 2015
(b) Fully phased in on 1 January 2019
Source: APRA

Some other countries have also committed to a more rapid implementation timetable and/or stricter requirements than those set by the BCBS. For example, the Monetary Authority of Singapore (MAS) recently announced a two-step process to increase the capital requirements for its locally incorporated banks. First, it will require them to meet the new Basel III minimum requirements two years ahead of the BCBS timeline: that is, they must hold common equity of 4.5 per cent of risk-weighted assets and Tier 1 capital of 6 per cent from 1 January 2013. Second, even higher requirements will apply from 1 January 2014, with the ratios ultimately increasing to 6.5 per cent and 8 per cent, respectively, by 1 January 2015. The MAS considered that the capital requirements for locally incorporated banks needed to be set higher than the Basel III minimum requirements because each of the locally incorporated banks is systemically important in Singapore and has a substantial retail presence. The China Banking Regulatory Commission has also announced that Chinese banks will be required to meet the new Basel III minimum capital requirements ahead of schedule and that systemically important banks in China will be subject to an additional capital charge of 1 per cent of risk-weighted assets, taking the minimum total capital ratio (including the conservation buffer) for these banks to 11.5 per cent.

The recent recommendations of the UK Independent Commission on Banking (ICB) also go further than the Basel III minimum requirements for UK retail banks. The ICB proposed the ring-fencing of UK retail banking operations within independent subsidiaries. For the large ring-fenced banks, defined as those banks that have a risk-weighted assets-to-GDP ratio of at least 3 per cent, the ICB proposed that by 2019 they should hold common equity of 10 per cent of risk-weighted assets and have primary loss-absorbing capacity (made up of capital and bail-in instruments) of at least 17 per cent. For the ring-fenced banks with a risk-weighted assets-to-GDP ratio of 1 to 3 per cent, it is proposed that they hold common equity of 7 to 10 per cent of risk-weighted assets and have primary loss-absorbing capacity of between 10.5 and 17 per cent.

The European Union announced proposals to implement Basel III through its fourth capital requirements directive, largely following the BCBS proposals in terms of the minimum capital ratios and implementation timetable. However, the EU proposals as published include a 'maximum harmonisation' rule, that is, a common Pillar 1 minimum requirement across members, to help ensure a level playing field and to discourage the practice of regulatory arbitrage whereby banks could relocate to those jurisdictions with the lightest regulatory burdens. There are exceptions to this rule, such as Pillar 2 capital add-ons, which may provide national regulators with additional flexibility if desired.

Shadow banking

The FSB is continuing its work to strengthen the oversight and regulation of the shadow banking system. This refers to non-bank financial institutions (such as securities firms and hedge funds) that engage in bank-like activities and hence are in the credit intermediation chain, but which are not subject to the same prudential regulation as banks. The FSB has focused its work in two areas: clarifying the scope of the shadow banking system and setting out potential approaches for monitoring it; and developing policy recommendations to address the systemic risk and regulatory arbitrage concerns posed by the shadow banking system. Monitoring and data-gathering will be aimed broadly at covering all activities and entities within which shadow banking-related risks might arise. In contrast, policy action would be focused more narrowly on the subset of non-bank credit intermediation that could pose systemic risks, and in particular focusing on key risks, namely maturity/liquidity transformation, flawed credit risk transfer and leverage. The Reserve Bank is represented on an FSB task force dealing with these shadow banking issues. As part of this work, the RBA provided information and data on Australia's shadow banking system, which is relatively small.[1] The FSB recently conducted a further data and

1 For more information, see RBA (2010), 'Box B: The Shadow Banking System in Australia', *Financial Stability Review*, September, pp 36–38.

information-sharing exercise as a step toward evaluating and adjusting its proposed frameworks. This could lay the basis for data collection and assessment by the FSB of global trends and risks in shadow banking from 2012 onwards. In international discussions on these issues, the RBA has been keen to ensure that the regulatory response to shadow banking systems is proportionate to the risks they pose, and that these will vary across countries, including in accordance with the size of each country's shadow banking system. The FSB will elaborate on its high-level recommendations regarding shadow banking in a report for the G-20 in October.

In future work, the FSB is planning to assess the case for additional regulatory action in four areas: banks' interaction with shadow banking entities; money market funds and other shadow banking entities (such as finance companies and conduits); securitisation; and securities lending and repos. The FSB has decided to set up dedicated workstreams to focus on each of these areas, with the work either being undertaken by the relevant international standard-setting bodies or under FSB guidance. The workstreams will report their progress as well as proposed policy recommendations to the FSB by July 2012 (or end 2012 for securities lending/repos).

OTC derivatives markets

The FSB, along with relevant standard-setting bodies, is continuing to oversee work on reforming OTC derivatives markets. Much of the current work in this area is the responsibility of national authorities. The FSB's role has been to help ensure previously agreed G-20 commitments are implemented in an internationally consistent and non-discriminatory manner, in order to meet key deadlines. Recent discussions at the FSB have noted that, although implementation is still in its early stages, many jurisdictions may not meet the key deadlines without substantial steps being undertaken. The FSB is continuing to monitor developments through its OTC Derivatives Working Group as implementation progresses, and will identify any further emerging inconsistencies that would need to be addressed by authorities.

One of the G-20 commitments is that all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties (CCPs) by end 2012. In order to accelerate domestic progress on the commitment to central clearing, the Reserve Bank, on behalf of the CFR, recently issued a discussion paper 'Central Clearing of OTC Derivatives in Australia'. The paper discussed the evolving global landscape for OTC derivatives and central clearing, the Australian market for OTC derivatives and several issues that need to be considered if central clearing in the domestic market is to be established. This work is required, in part, because of the substantial reforms in this area underway in many offshore jurisdictions which will change the international environment for central clearing and will give important impetus to the use of central clearing services by Australian banks. A key question is whether Australian dollar-denominated interest rate derivatives should be centrally cleared through an Australian-domiciled CCP. The consultation represents an important step in developing an appropriate Australian regulatory framework. Another impetus to Australian banks using central clearing will come from the implementation of Basel III, which includes higher capital requirements for non-centrally cleared derivatives contracts compared with those cleared centrally.

Macroprudential policy frameworks

The Bank for International Settlements (BIS), FSB and International Monetary Fund (IMF), have continued their joint work identifying best practices for macroprudential policy frameworks. The three bodies are expected to submit a joint progress report to the November 2011 G-20 Summit, outlining advances in the state of knowledge and covering national and international progress in developing these frameworks. This work is at a preliminary stage compared with most of the other regulatory

initiatives. As such, much of it is focused on exchanging experiences in order to advance the policy debate.

The BIS, FSB and IMF have facilitated these discussions, including between national authorities, over the past year. The Reserve Bank has contributed to these discussions and in doing so several points have been emphasised, drawing mostly on the Australian experience.

- Macroprudential policy can be regarded as a subset of financial stability policy. If the financial stability framework is effective and there is strong inter-agency co-operation and co-ordination, separate governance arrangements for macroprudential policy are not necessary.
- Some of the advocacy of separate macroprudential policy is based on a lack of recognition as to how prudential supervisors do their work. Many are not solely microprudential in outlook, focusing only on individual institutions' adherence to regulations; they can and do take account of system-wide, or macroprudential, considerations.
- Ideally, both microprudential and macroprudential policies and responsibilities should be integrated. More generally, most macroprudential tools being discussed are essentially normal prudential tools used for macroprudential purposes, which also means a clear distinction between macro- and microprudential policy is impractical.
- Tools that have been adopted in emerging markets, and which are now being characterised as macroprudential, might not be effective in countries with more advanced and flexible financial systems.

Some jurisdictions have recently established new bodies to oversee financial stability issues and in particular macroprudential policies. This has typically been in countries where weaknesses in existing co-ordination arrangements became evident during the global financial crisis. Other countries, such as Australia, already have strong regulatory co-operation and financial stability oversight arrangements; in Australia's case this is through the CFR and the relevant mandates of the four CFR agencies.

FSB peer review process

The FSB is nearing completion of a country peer review of Australia, which has been underway this year. The review is part of an FSB program that examines all of its members' financial sectors, especially their progress in meeting IMF Financial Sector Assessment Program (FSAP) recommendations. The review of Australia focused on Australia's follow-up to relevant recommendations from the 2006 FSAP and features of the financial landscape that supported Australia's relatively strong performance during the recent crisis. Along with other CFR agencies, the Reserve Bank contributed material to inform the review, the report of which is expected to be published by the FSB shortly.

In separate FSB peer reviews, the Reserve Bank was represented on an expert team reviewing mortgage lending practices and is also part of a follow-up group developing an international principles-based framework for sound mortgage lending practices. The Australian Treasury is participating in a follow-up thematic cross-country review of financial sector compensation practices to assess country progress since a 2010 review. A thematic cross-country review of deposit insurance systems is also underway.

FSB regional consultative groups

As part of its outreach program, the FSB recently established regional consultative groups bringing together financial sector authorities from FSB member and over 60 non-member jurisdictions to exchange views on vulnerabilities affecting regional and global financial systems and on current and potential initiatives to promote financial stability, and the implementation of these initiatives. Six groups

have been established covering the Americas, Asia, the Commonwealth of Independent States, Europe, the Middle East and North Africa, and Sub-Saharan Africa. The FSB recently finalised the operational framework for the six groups and their first meetings will take place later in 2011. Australia is included in the Asian grouping and the RBA, along with the Australian Treasury, will participate in these meetings as required.

Domestic Regulatory Developments

Financial Claims Scheme

The CFR continues to review Australia's financial crisis management arrangements to ensure they take account of international experiences and developments. One aspect of this work over the past year has been reviewing issues related to the FCS. The FCS protects depositors by providing them with certainty that they will recover their protected deposits in the event that an ADI becomes insolvent. It also provides depositors with quick access to the deposit funds covered by the Scheme. The FCS was introduced in October 2008 at the height of the global financial crisis, so some of its features were set to address the particular concerns over global financial stability at that time. When it was introduced, the Government committed to reviewing a number of the Scheme's settings by October 2011. In order to support this review, the CFR undertook an assessment of whether the current structure of the FCS is suitable for the post-crisis environment. Its advice informed the Government's revised arrangements, which were subject to a public consultation process prior to their finalisation in September. The main feature of the revised arrangements for the FCS is a reduction in the level of the cap to $250 000 per person per ADI from 1 February 2012. The Government also intends to make legislative changes to the existing framework to improve the effectiveness of the FCS, including: removing coverage of foreign branches of Australian-incorporated ADIs; enabling an additional payment option which allows APRA to transfer deposits to a new institution; establishing a 'look-through' mechanism for pooled trust accounts; and enabling the Treasurer to activate the Scheme earlier than the point of winding up.

Financial market infrastructure

In April, the CFR was asked by the Government to examine a number of issues relating to financial market infrastructure regulation. In particular, the Government asked the CFR for advice on measures which could be introduced to ensure Australia's regulatory system for such infrastructure continues to protect the interests of Australian issuers, investors and market participants, including under a scenario where key infrastructure such as an exchange or CCP is part of a foreign-domiciled group. The issues to be addressed include the adequacy of oversight, powers of direction, and crisis management arrangements for market operators and clearing and settlement facilities. It is anticipated that a consultation paper seeking stakeholder views on these issues will be released later this year.

Following the finalisation by the Australian Securities and Investments Commission (ASIC) of the regulatory framework for competition between markets trading equities, Chi-X Australia (Chi-X) was granted a market licence by the Minister for Financial Services and Superannuation in May 2011. Chi-X plans to offer an alternative platform for trading in ASX-listed equities and, on launch, its trades will be cleared and settled by the ASX facilities.

A new derivatives exchange, the Financial and Energy Exchange (FEX), has also applied for a market licence. FEX plans to offer trading in commodity, energy and environmental derivatives, and has contracted LCH.Clearnet Limited (LCH) to provide clearing and settlement. LCH is a London-based CCP that clears equities and derivatives for a number of exchange-traded and OTC markets overseas. It is regulated and supervised by the UK's Financial Services Authority. In order to clear for FEX, LCH has applied for an Australian clearing and settlement facility licence.

Covered bonds

As foreshadowed in the March 2011 *Review*, following public consultation, the Government has recently introduced legislation into Parliament permitting ADIs to issue covered bonds, which are debt instruments that are backed by a segregated pool of high-quality assets. The legislation provides for issuance of covered bonds to be limited by a cap placed on the value of the cover pool of assets, with the cap to be set at 8 per cent of an ADI's assets in Australia. This cap prevents covered bondholders having claim over more than 8 per cent of an ADI's assets in Australia at the point of issuance of covered bonds, which has the effect of limiting the subordination of unsecured creditors such as depositors in the event an ADI is wound up. To ensure adequate security for covered bondholders, the ADI would be required to maintain the cover pool of assets so that the value of these assets is sufficient to meet 103 per cent of the face value of the outstanding covered bonds. This may involve the ADI transferring additional assets to the cover pool and/or replacing assets in the cover pool over time. Under the legislation, APRA would have certain powers relating to covered bonds, including the power to set prudential standards with respect to the issuance of covered bonds by ADIs, and to disallow the issuance of covered bonds in certain circumstances.

Financial advice

The Government has recently released draft legislation to amend the law regulating the provision of financial advice. The underlying objectives of the changes are to improve the quality of financial advice, better align the interests of the adviser with the client and reduce conflicts of interest. The reforms also focus on facilitating access to financial advice, through the provision of low-cost 'simple advice'. The draft legislation includes:

- an obligation for financial advisers to act in the best interests of their clients and to place the interests of their clients ahead of their own when providing personal advice to retail clients;
- a requirement for providers of financial advice to obtain client agreement to ongoing advice fees and enhanced disclosure of fees and services associated with any ongoing fees; and
- changes to ASIC's licensing and banning powers in relation to the financial services industry.

In addition, draft legislation is expected to be released for consultation shortly relating to the proposal to ban conflicted remuneration, including commissions, volume payments and soft-dollar benefits.

Advertising of financial products

ASIC is currently developing best practice guidance for the advertising of financial products and financial advice in order to better inform investors and consumers of financial services in making financial decisions. In August, ASIC released for consultation proposals on guidance to assist promoters and publishers of financial products and financial advice services in presenting advertisements that are accurate and balanced. It is proposed that the guidance would apply to both general and personal financial product advice and all types of financial products, including: investment products; risk products; non-cash payment facilities; and credit facilities. There is less of a focus on credit facilities initially, with additional guidance for credit providers and providers of credit services under the *National Consumer Credit Protection Act 2009* to come at a later date.

The proposals are intended to complement existing ASIC guidance on general financial product disclosure statements and prospectus disclosure obligations, as well as the disclosure guidance that ASIC currently provides for certain financial products due to their risky or complex nature, such as debentures, mortgage schemes and unlisted property schemes.