

FINANCIAL SYSTEM STABILITY

Although the RBA no longer has responsibility for supervision of individual financial institutions, it retains a mandate for the overall stability of the Australian financial system. In addition, the RBA is responsible for the soundness of the payments system, and is itself an important participant in the wholesale payments system. As a result, in the event of a serious threat to financial stability, the RBA could be required to take action. Such arrangements are common to other countries where the central bank is not the prudential regulator of banks.

In pursuing its mandate for financial stability, the RBA monitors the health of the Australian financial system through a range of “macroprudential” or financial soundness indicators. These include measures of the financial condition of major groups of borrowers (the household and business sectors); aggregate prudential data on the strength of financial institutions; market-based information on credit spreads and credit ratings; and readings on the key markets in which financial institutions operate. These indicators, taken together with information which the RBA receives in the course of its normal market and settlement activities, should provide pointers to potential vulnerabilities facing the financial system.

While the global financial system was spared shocks of the severity experienced in the previous year – which included the largest ever corporate and sovereign defaults – 2002/03 was, nonetheless, not an easy year from a financial stability perspective. Uncertainty about the trajectory of world economic growth and greater caution on the part of investors unsettled financial markets, while geopolitical uncertainties over Iraq and the Korean peninsula at

times weighed heavily on market confidence. The Australian financial system is not quarantined from global developments but, in the RBA’s assessment, it remains in a strong condition, supported by the continued expansion of the Australian economy. However, the substantial build-up in household debt may create strains for any financial institutions that have lowered their guard, if Australia’s economic circumstances were to deteriorate.

The Stability of the Australian Financial System

The International Environment

Over the first three quarters of 2002/03, and as tensions in Iraq built, uncertainties about prospects for growth in the major economies and a retreat by investors from risk-taking combined to generate various signs of stress in the global financial system. Credit spreads in the corporate bond market reached historical highs in many countries, though they later fell substantially as investors switched from equities to fixed-interest markets; equity markets fell sharply; and the balance sheets of financial institutions came under pressure in a number of countries. The quick resolution of the Iraq conflict gave a lift to market sentiment and encouraged a return to equity markets, but confidence that global growth will regain momentum is not yet securely founded.

The robustness of the global financial system through recent upheavals owes much to the resilience of banking systems in most of the major industrial countries. Banks with strong retail franchises have performed reasonably well. The US banking system, in particular, has been characterised by healthy levels

of capital and low levels of non-performing assets notwithstanding the sluggish US economy. Improvements in the management of credit risk and operating costs and a positively sloped yield curve have helped the US banking index to out-perform the broader US equity market for some time. A similar story is evident in the United Kingdom and a number of other European countries.

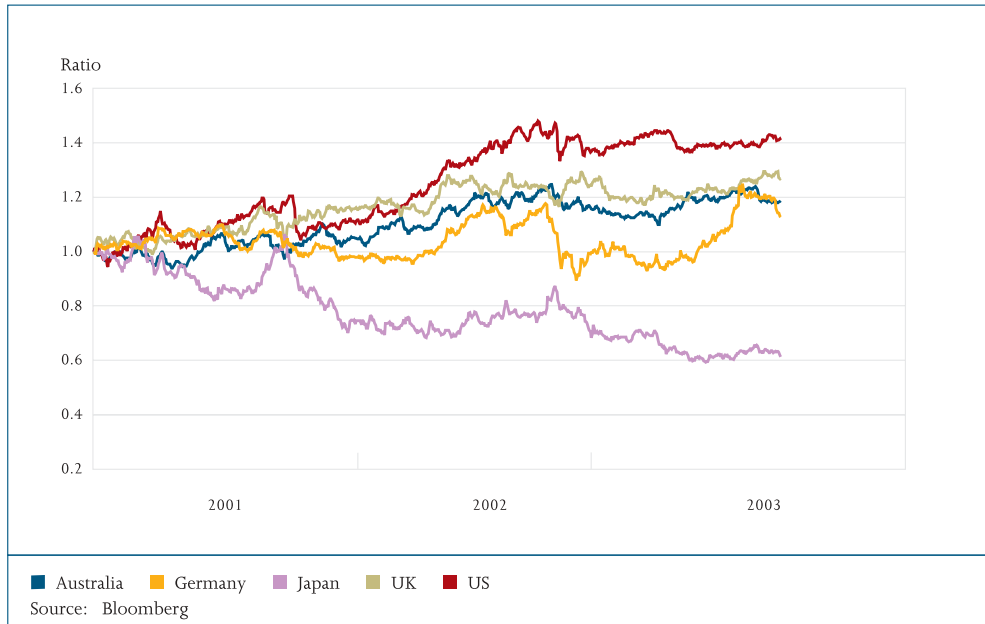
Nonetheless, clear areas of weakness have emerged. Banks that rely heavily on wholesale business have come under considerable pressure. Seven of the ten largest international banks have had their long-term rating downgraded by at least one of the major credit-rating agencies since early 2001. Markets dealt severely with international banks that mismanaged major credit exposures or suffered reputational losses and legal liabilities from dubious business practices.

In addition, the banking systems of two of the major industrial countries have been under stress. In Japan, banks continue to grapple with deflation, the unwinding of Japan's earlier asset price bubble and

persistent impaired asset problems. Progress in dealing with impaired assets has been slow; recent official estimates suggest that some 9 per cent of the total loans of Japanese banks are non-performing and private-sector estimates are much higher. In May, the Japanese Government agreed to inject public funds into Resona Holdings, the country's fifth largest bank, to stave off its collapse. In Germany, a highly fragmented banking system has struggled with a sizeable non-performing loan burden, low levels of profitability and a significant exposure to equity markets. Since early 2002, German supervisory authorities have felt the need to issue statements of support for German banks. More recently, sentiment towards the German banking sector has improved considerably, partly reflecting restructuring initiatives and the increasing value of their direct holdings of shares.

During 2002/03, the insurance sector remained a source of concern in many countries. This sector plays a critical role in absorbing risk in the financial system – including, increasingly, as buyers of credit

GRAPH 1 | BANKS' SHARE PRICES Relative to equity market



risk from banks through credit derivatives. For this reason, the financial condition of the sector and its future appetite for risk have become a major focus of international policy makers. The main difficulty confronting insurance companies is a weak flow of investment income. This problem is especially acute for life insurance companies in countries such as Germany, Switzerland and the UK, where the profitability of annuity products depends heavily on equity and fixed-interest returns exceeding guaranteed rates of return on policies. The impact of this problem has been felt in the Australian market through the UK operations of AMP. Insurance companies have responded to losses on their investment portfolios by raising capital and reducing their equity holdings. In some cases, supervisory authorities have relaxed equity valuation rules to reduce pressure on insurers to sell their equities into declining markets.

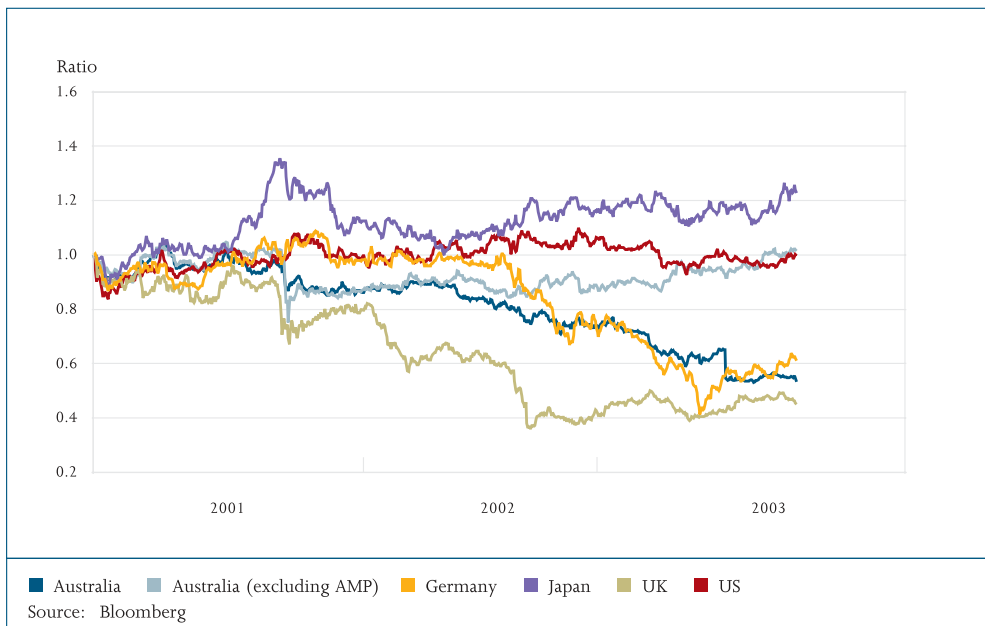
External Vulnerabilities

Global economic and financial conditions impinge

upon the Australian economy and Australian financial markets in various ways and these are monitored closely by the RBA in the setting of monetary policy. From a financial stability perspective, the key issues are the exposure of Australian financial institutions to global developments, through both their lending and funding activities.

On the assets side of the balance sheet, Australian banks' offshore exposures have remained broadly constant over the last decade or so – at a little under one third of total assets – but their geographic composition has changed somewhat. Lending to Japanese borrowers has diminished significantly in importance while lending to borrowers in New Zealand has risen to become the single largest country exposure, a little above the UK. The risks facing Australian banks in their New Zealand and UK operations – where strong growth in mortgage lending has fuelled house price appreciation – bear close similarities with their exposures to Australian borrowers.

GRAPH 2 | INSURERS' SHARE PRICES Relative to equity market



Australian Banks' Lending to Overseas Economies			
Per cent of total assets			
	1990	1996	2002
New Zealand	3.7	8.3	8.6
United Kingdom	8.3	7.1	8.0
Euro area	2.8	2.5	4.4
United States	5.5	3.9	3.9
Japan	5.0	2.7	0.6
Other	4.6	5.1	5.3
Total	30.0	29.6	30.8

Source: APRA

On the liabilities side, Australian banks have turned increasingly to offshore markets as a source of funding to supplement their domestic deposit base. The major banks now source around one quarter of their liabilities offshore, up from about 10 per cent at the start of the 1990s. A significant part of these liabilities has been raised in Australian dollars, through banks issuing in offshore markets where there is strong demand for Australian dollar assets. So-called "uridashi" issues to retail investors in Japan, in particular, have been popular in the past two years or so. Nevertheless, about 65 per cent of banks' offshore liabilities are denominated in foreign currencies. On international comparisons, Australian banks appear to have much higher levels of net foreign currency liabilities than is the case in most other industrialised countries.

Some have seen this structure of liabilities as a potential source of external vulnerability for the Australian financial system. One aspect of such concerns is the belief that the banks are exposed to significant foreign exchange risk. As the RBA has explained in its *Bulletin* (August 2000 and August 2002), this is, in fact, not the case. In aggregate, the large net foreign currency liabilities which appear on banks' balance sheets (and in the national statistics based on those balance sheet figures) are offset by off-balance sheet derivatives positions. Taking the on-balance sheet and off-balance sheet exposures together, survey data in 2001 showed that Australian

banks actually had small net foreign currency assets. More recent information shows that banks' foreign currency exposure remains at relatively low levels.

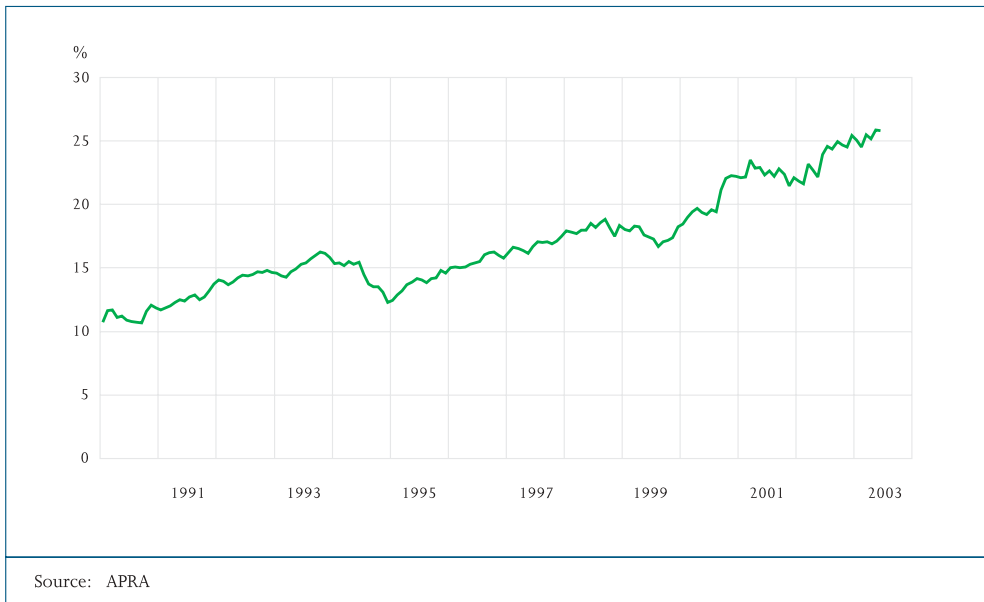
Banks' Foreign Currency Exposure	
June 2001	\$b
Net FX position on debt	-117
Foreign equity assets	31
Net position on FX derivatives	109
Overall position	23

Source: ABS

Banks' foreign currency borrowings have been undertaken as one element in a strategy which involves the matching use of off-balance sheet cross-currency swaps to convert the foreign currency exposure into an Australian dollar exposure. The result is that the banks are able to obtain Australian-dollar funding at a lower cost than they could achieve by borrowing directly in the Australian market. Since the borrowings and swaps are matched, the banks face negligible foreign exchange risk through this strategy. When the exchange rate moves, gains or losses on the original foreign currency borrowings are offset by corresponding losses or gains on the swaps.

A second concern raised about banks' use of offshore funding is that they are exposed to greater refunding risk (the inability to renew a borrowing facility when it matures). This concern rests on the view that offshore markets are more prone to flight than domestic markets. This could happen if, for example, foreign investors lost confidence in the economic fundamentals and policy settings of Australia or, at the level of the individual borrower, if a credit-rating downgrade raised doubts about that borrower's asset quality and ability to repay borrowings. In either case, international capital markets would likely demand more favourable terms for any funding through a lower exchange rate and higher interest rates. Australian banks would then

GRAPH 3 | AUSTRALIAN BANKS' FOREIGN LIABILITIES On balance sheet (domestic book), per cent of total



find the pricing of offshore funding unattractive and would unwind their overseas borrowings and the associated swap facilities in parallel. Funding would be switched to onshore markets. This would put some pressure on domestic security yields as the Australian banks increased their call on local wholesale markets but, given that the funding would mainly be at the short end of the yield curve, which is largely fixed by the RBA, the rise in yields would be only at the margin. In summary, the RBA's assessment is that Australia's banking sector would not be unduly impaired by sudden changes in the exchange rate or in global funding markets, even though banks are active users of these markets.

This conclusion extends more broadly to other aspects of Australia's external position. In recent years, there has been an increase in interest in measuring the external vulnerability of countries. Much of the impetus has come from the Asian and other financial crises of 1997-98 and has therefore focussed on issues of particular relevance to emerging market economies. It was in this context that the International Monetary Fund (IMF)

identified in 2000 a group of key debt-related and reserve-related indicators which it has since used as a basis for discussions with country authorities. But there has also been heightened interest in the study of external vulnerability, and financial fragility more generally, in industrialised countries. Emerging and industrialised countries have pledged to undertake reviews of these matters as part of the Financial Sector Assessment Program, under the auspices of the IMF and World Bank.

In this context, and despite significant reservations about applying to industrialised countries concepts intended for use in emerging market economies, the RBA has studied the potential for the IMF's indicators to be used to draw conclusions about financial vulnerability in Australia. The central focus in this work has been on understanding the reasons for Australia's overall high level of net foreign liabilities (and the Australian banking system's high level of foreign currency liabilities, discussed above).

Australia does have a high level of net external liabilities. That level rose from about 25 per cent of GDP in 1983 to about 55 per cent of GDP in 1993,

and has since remained relatively steady. However, most of Australia's gross external liabilities – about 60 per cent – are denominated in Australian dollars, while almost all of our gross external assets are in foreign currencies. As a result, Australia's net foreign currency position is one of surplus – the country has net foreign currency assets equivalent to about 10 per cent of GDP. When off-balance sheet positions (such as swaps undertaken by the banking sector) are taken into account, Australia's net foreign currency asset position is even larger, at about 20 per cent of GDP. This net foreign currency asset position means that Australia as a whole is not vulnerable to any significant degree to currency valuations associated with even large falls in the exchange rate.

Australia also has a low level of foreign reserves, especially – as is often done in analyses of external vulnerabilities – when compared to the high level of short-term, on-balance sheet debt. For several reasons, however, this does not indicate a high degree of vulnerability. First, foreign reserves are a more relevant indicator for countries with fixed or managed exchange rate systems than for countries with a floating exchange rate, such as Australia. Secondly, most of Australia's on-balance sheet debt is denominated in Australian dollars and, of the remainder, about half has been hedged back to Australian dollars using derivatives. Thirdly, Australian borrowers are likely to have continuing access to global funding markets even in otherwise difficult circumstances, as proved to be the case during the Asian and other financial crises of 1997-98.

The RBA's judgment that Australia's low ratio of foreign reserves to short-term debt does not pose a significant economic risk is also borne out by the assessments of financial markets themselves, as reflected in credit ratings by the major ratings agencies. A relatively low ratio of foreign reserves to short-term debt is also common across many medium-sized industrialised countries which have floating exchange rates, and which share with Australia a relatively high credit rating. On the other hand, many countries with high levels of international reserves have lower credit ratings.

Ratio of Reserves to Short-term Debt and Credit Ratings

	Reserves/debt	Credit rating
Switzerland	0.2	AAA
Sweden	0.2	AA+
Australia	0.2	AAA
Canada	0.3	AAA
New Zealand	0.4	AA+
Brazil	1.2	B+
Mexico	1.7	BBB-
Indonesia	2.1	B-
Korea	2.6	A-
Thailand	3.5	BBB-
Malaysia	3.6	BBB+

Domestic Developments

The main feature of domestic developments in 2002/03 was the exceptionally fast pace in growth of credit extended by Australian financial institutions to the household sector, particularly for housing. Growth in credit to business, which had picked up around mid year, was more subdued over the latter months, but growth in total credit, at around 12³/₄ per cent, was above its recent average.

These developments have continued the trend evident over the past decade or so which has seen a shift in the proportion of lending by financial institutions away from the business sector and towards lending to households. Lending to the latter group now accounts for about 56 per cent of total credit, compared with less than 40 per cent in 1990. The switch in emphasis is due, in part, to the strength of corporate profits and positive share market sentiment over much of the period, which have enabled businesses to make greater use of internal funding and equity raisings for expansion. Growth in the corporate bond market has played a role as well. The switch is also due to strategic decisions by some major financial institutions to favour lending to households in the wake of their corporate loan loss experiences in the early 1990s. The divergent credit trends have led to a shift in the structure of assets held by financial institutions towards lower-risk loans and, as a consequence, average credit quality has improved.

Lending to the household sector – about four-fifths of which is secured against housing – has been growing at double-digit annual rates for some time now. This has been associated with substantial and widespread increases in house prices and, in the past few years, with increased purchases by investors. Consequently, household debt is now equivalent to 129 per cent of annual household disposable income, at the high end of the range of other comparable countries.

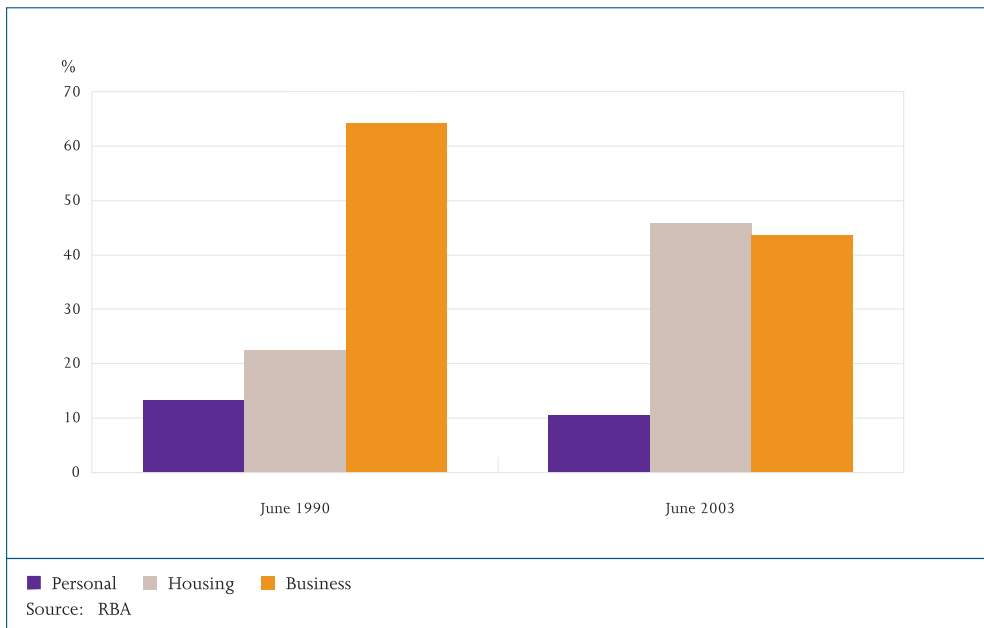
These developments have raised the financial risks facing that proportion of households (around 30 per cent) which have housing debt, a concern to which the RBA has drawn attention on a number of occasions recently. At this juncture, however, there are no obvious signs of financial stress in the household sector. Interest rates remain at historically low levels and the aggregate interest burden – interest paid as a share of income – is below its peak in the late 1980s/early 1990s, although it is trending upwards as the average size of housing loans rises. Many households have a significant cushion from repaying

debt ahead of schedule (though others are topping up their debt through redraw facilities), and late payments (past-due) on housing and other personal loans are close to cyclical lows. Growth in employment and wages has tended to support household incomes and debt-servicing capacity.

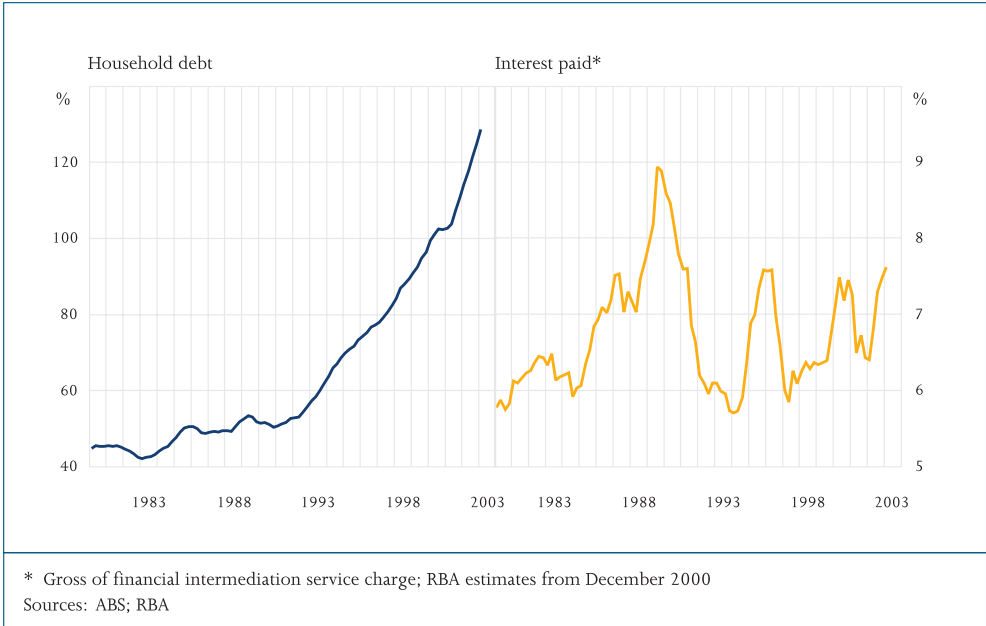
Latest readings confirm that the financial position of the business sector is sound and, with ample funding for investment plans available from internal sources, the sector had only limited additional recourse to the banking system in 2002/03. Corporate profitability remains high, and although the drought has had an impact on rural producers, the profitability of other unincorporated enterprises is generally favourable compared with recent years. Debt ratios are well below their peak of the late 1980s and interest burdens are around historically low levels. Credit spreads for both low- and high-grade corporate debt have declined to relatively low levels.

Within business lending, two sectors have been under somewhat closer scrutiny. The first is the rural sector, which has been weakened by drought.

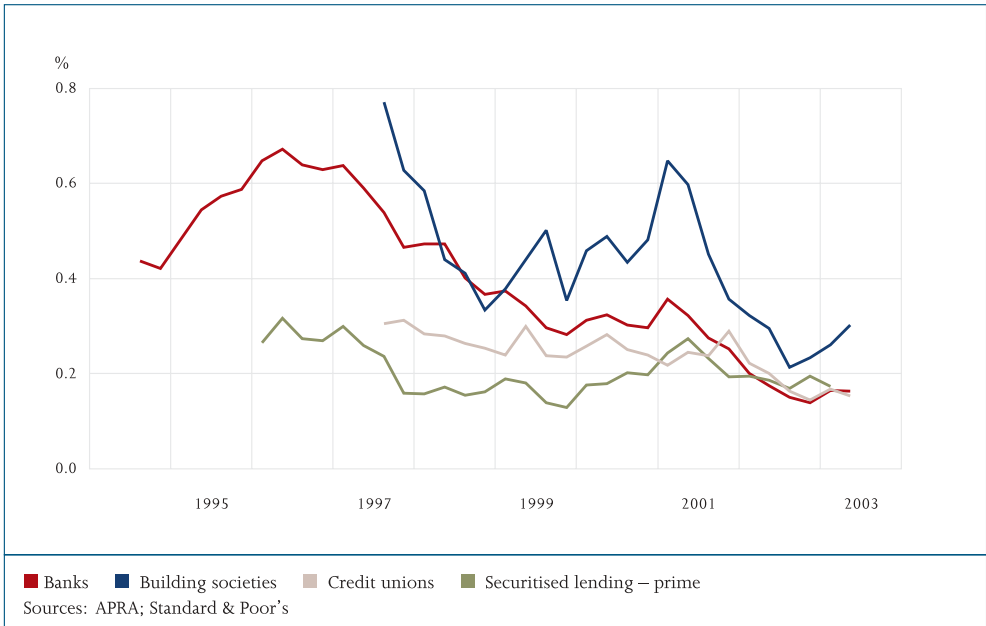
GRAPH 4 | CREDIT BY SECTOR Per cent of total



GRAPH 5 | HOUSEHOLD DEBT AND INTEREST Per cent of household disposable income



GRAPH 6 | HOUSING LOANS PAST DUE Per cent of total value of housing loans



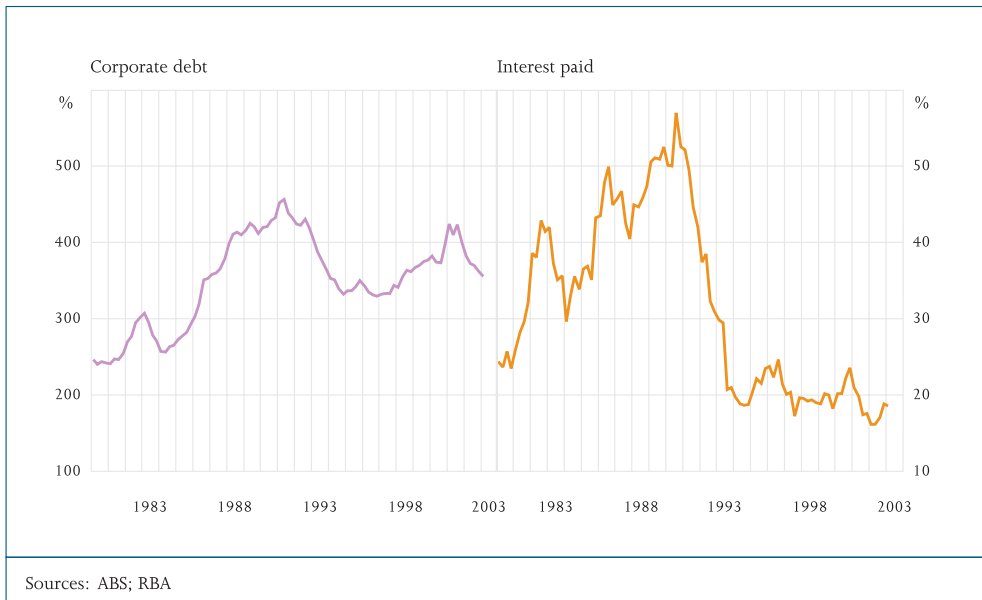
Notwithstanding sharp falls in production and the impact on some rural communities, the drought and its consequences are unlikely to threaten financial stability. Lending to the rural sector accounts for less than five per cent of total credit provided by banks. The interest burden of the rural sector is low both in historical terms and relative to other industries, and declines in revenue seem manageable in light of tax-effective saving instruments (such as Farm Management Deposits) and the previous run of good rural profits.

The other sector under scrutiny is office property, where earlier episodes of over-investment have been the source of stress on the financial system. Conditions in the office property market have softened a little recently, but have generally held up well considering the bursting of the “high tech” bubble and financial sector downsizing which pushed up vacancy rates in some areas. Nonetheless, current conditions seem more sustainable than those in the late 1980s: price rises over recent years have been far more muted and the build-up in supply of office accommodation has been much less pronounced. Banks have considerably

reduced their exposures to office property to around three per cent of total bank credit (and to commercial property in general to around 13 per cent) and have strengthened their risk management procedures in this area.

Reflecting the general health of the household and business sectors, the overall financial condition of authorised deposit-taking institutions in Australia remains strong. The financial soundness indicators which the RBA monitors – including asset quality, capitalisation, profitability and market valuation – continue to provide reassuring readings. Asset quality remains robust. For banks, the ratio of impaired assets to total assets was 0.5 per cent at year-end, around the very low levels established during the course of the current economic expansion. “Distressed” assets, a broader measure which includes loans on which payments are late, were 0.7 per cent of total assets. Impaired asset ratios for building societies and credit unions are also around cyclical lows. These measures of asset quality are, of course, backward-looking and more forward-looking indicators strike a note of caution. A number of banks have noted potential for

GRAPH 7 | CORPORATE DEBT AND INTEREST Per cent of gross operating surplus



increased loan delinquencies in parts of their household and business exposures, and some have tightened lending standards accordingly. In particular, on new investment loans – particularly for apartments in some inner-city suburbs – major banks have lowered the maximum proportion of the purchase price that can be borrowed.

Financial intermediaries have strong lines of defence against any deterioration in credit quality. Banks hold general provisions of around 0.5 per cent of total assets against the possibility of future losses not attributable to particular assets. The ratio of specific provisions (written against assets already identified as impaired) to total assets is lower, reflecting the sustained improvement in asset quality over recent years. Banks maintain aggregate capital ratios of around 10 per cent of risk-weighted assets, well above minimum required levels. The comparable ratios for building societies and credit unions are around 14-15 per cent.

Notwithstanding the compression of interest margins over recent years, banks in particular have been able to maintain high levels of profitability by

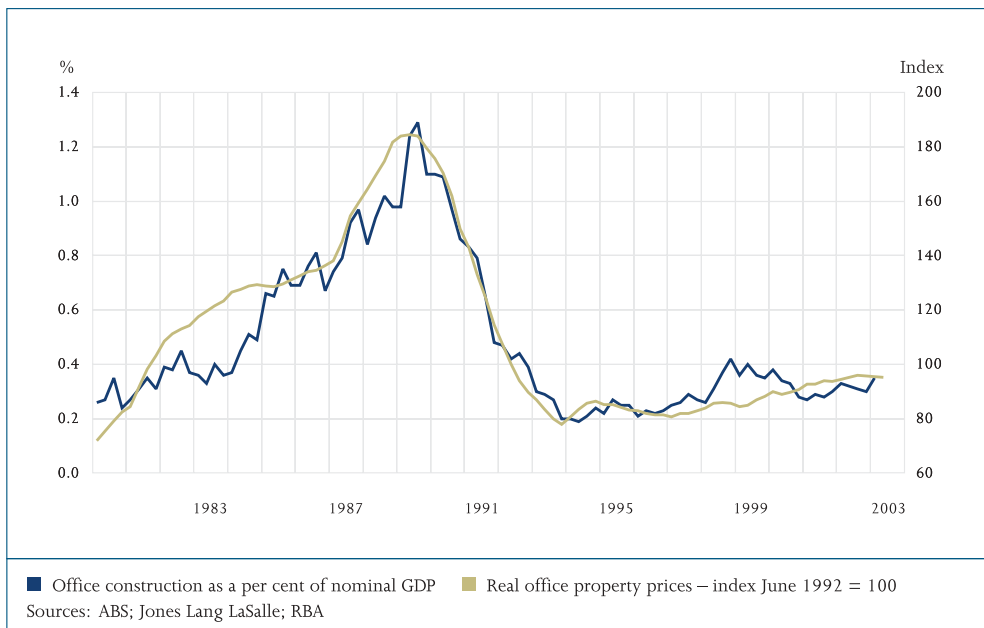
enlarging their asset base, containing costs and diversifying income sources. For the major banks, non-interest income now accounts for almost half of total income, a proportion boosted by recent acquisitions of funds management businesses. Declining equity markets have been taking their toll on funds management activities, but retail banking franchises remain very profitable.

Market indicators continue to signal a generally positive view of the credit quality of Australian banks. Despite a retraction in the first part of 2002/03, since reversed, bank share prices have outperformed the broader market over a long period. Average spreads on long-term US dollar bonds issued offshore by Australian banks have regularly been lower and less volatile than the average spreads on comparable debt of their overseas counterparts.

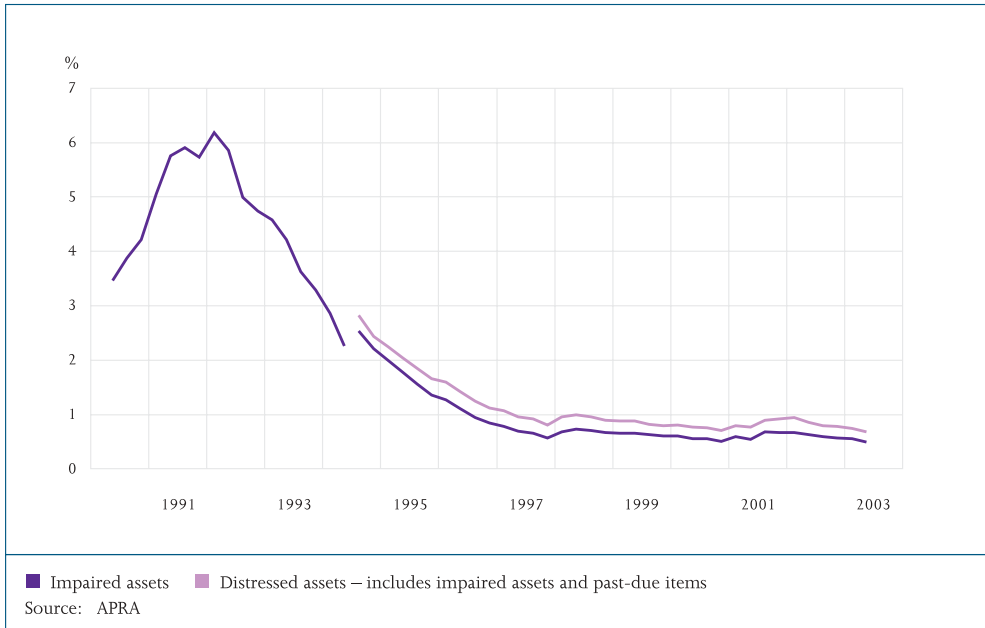
Outlook for Financial Stability

Looking ahead, the main potential source of risk to financial stability would be a substantial correction in the housing market, impacting on the balance sheets of authorised deposit-taking institutions through mortgage defaults. At this point, there are

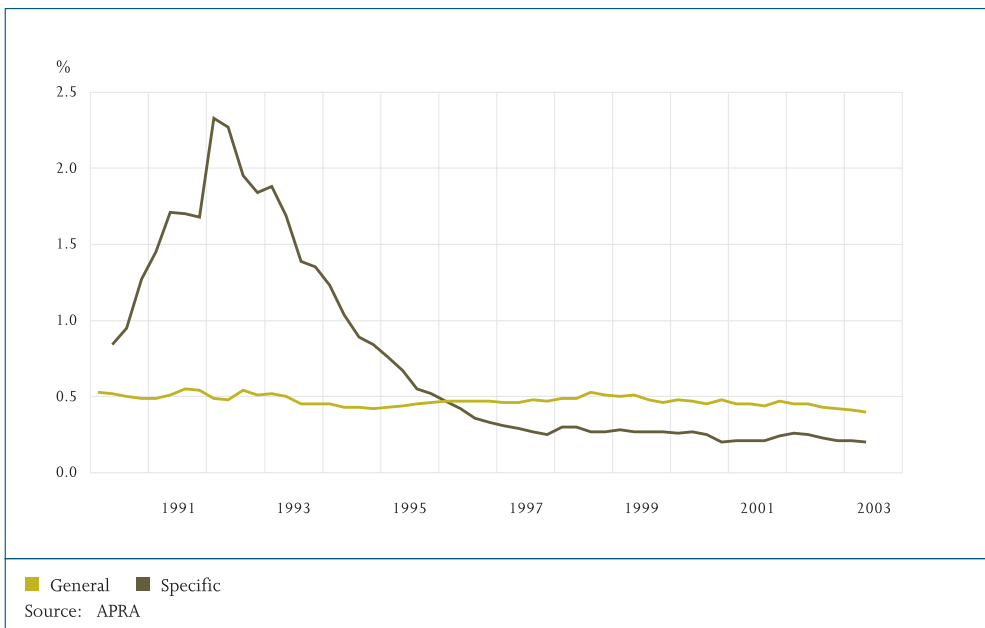
GRAPH 8 | OFFICE PROPERTY INDICATORS



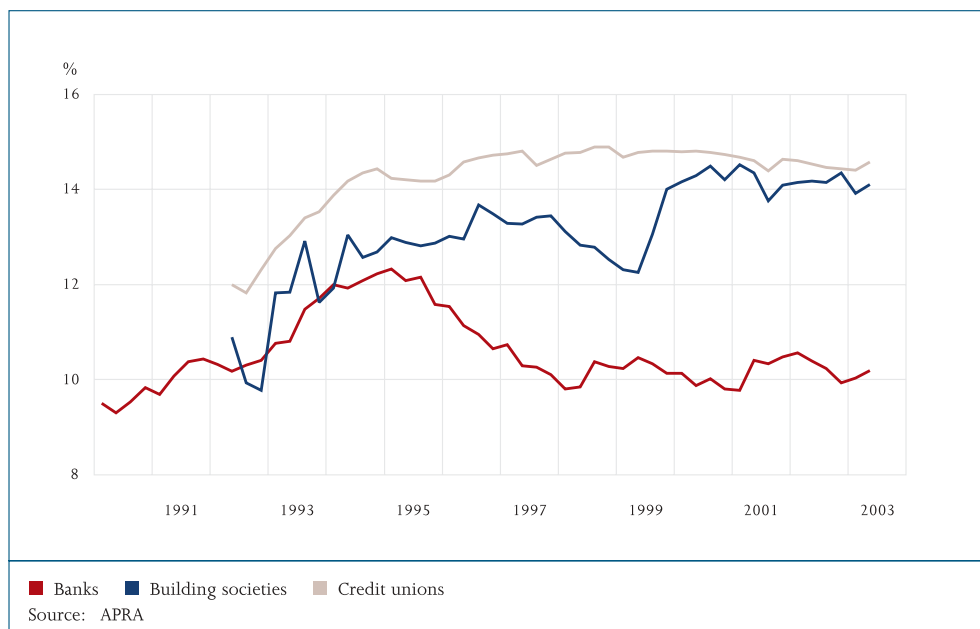
GRAPH 9 | **DISTRESSED ASSETS OF BANKS** Per cent of on-balance sheet assets



GRAPH 10 | **PROVISIONS FOR BAD AND DOUBTFUL DEBTS OF BANKS** Per cent of on-balance sheet assets



GRAPH 11 | RISK-WEIGHTED CAPITAL RATIOS



only limited signs of an easing in pressure in the housing market. A flattening or modest reversal of house price increases would not in itself be a cause for concern. The concern would be a sharp jump in mortgage default rates which triggered a more substantial market correction – a scenario more likely to be associated with a deterioration in employment conditions or sharp rise in interest rates.

The rapid increase in lending for housing, particularly for property investment, may harm borrowers carrying substantial exposures to an already over-extended apartment market. From a financial stability perspective, however, the current assessment is that the rise in household debt to date does not pose a significant danger of a financial crisis, such as occurred in the early 1990s after the build-up in corporate debt. This assessment is underpinned by the general strength and profitability of authorised deposit-taking institutions in Australia over a sustained period. It also takes into account developments that are specific to lending for housing. The first is the risk management procedures followed by these institutions and the “internal

buffers” on which they may draw. The second is the extent to which risks on lending for housing are being transferred to other risk-takers.

To guard against the risk of a significant increase in mortgage delinquencies, authorised deposit-taking institutions apply various “stress tests” to their housing loan portfolio, typically looking at the impact of higher interest rates, rising unemployment and falling house prices on expected default rates and losses. A key benchmark in loan application processes is the capacity of the borrower to service increases in interest rates, normally taken to be two percentage points. For lending to investors, institutions generally allow for falling rental yields by discounting the expected rental income for probable intervals of vacancy. Recently, APRA has supplemented these screening exercises with rigorous tests of its own; it has also found cause to voice concerns about slippages in property lending processes.

If default rates were to rise, lenders have two internal buffers on which to draw: the value of equity supporting the housing loan – commonly measured as the loan-to-valuation ratio (LVR) – and the excess

repayments that borrowers have made at their discretion. Low LVRs and high excess repayments both increase the assurance that a lender's exposure at default will be covered by the expected proceeds from the sale of property held as underlying security. LVRs on new housing loans appear to average 65-70 per cent across lending portfolios. Evidence suggests that around two thirds of households with mortgage debt repay their housing loans ahead of schedule. On the other hand, an increasing number of households are now taking advantage of new lending products – such as home equity loans and redraw facilities – to top up their mortgages, ensuring that their debt levels remain higher for longer.

For housing loans with LVRs above 80 per cent, authorised deposit-taking institutions generally have protection in the form of mortgage insurance. In the event of default on an insured loan, the lender receives from the mortgage insurer any shortfall between the proceeds from the sale of the underlying security and the amount of the loan outstanding. Use of mortgage insurance is governed by APRA's prudential guidelines. To qualify for the concessional risk-weight applied to housing loans for capital adequacy purposes, loans which have an LVR above 80 per cent must be covered by mortgage insurance. If this cover is to be relied upon in hard times, mortgage insurers themselves need to be in a strong financial position, and APRA requires that they be at least A-rated. In determining credit ratings, ratings agencies require mortgage insurers to hold capital sufficient to cover a number of "worst-case scenarios", including a prolonged downturn in the economy and substantial falls in house prices. To achieve the highest rating, a mortgage insurer would need to be able to withstand an increase in insurance claims many times worse than its most serious historical claims experience.

Authorised deposit-taking institutions that cede credit risk to mortgage insurers face strict and ongoing reporting requirements on the condition of insured loans if they are to comply with the terms of their mortgage insurance contracts. These

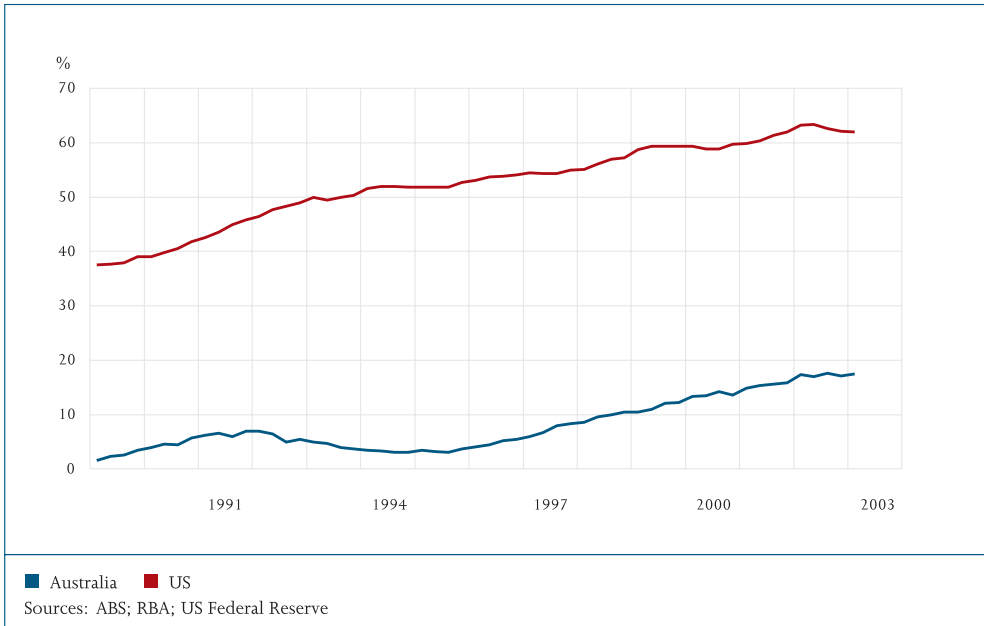
requirements may be easy to satisfy when delinquencies are few, but slippages in compliance may become an issue when default rates are increasing sharply – precisely when lenders most need the protection afforded by their mortgage insurance. APRA is currently giving this particular operational risk close attention.

Mortgage insurance is one of two main vehicles which lenders use to shed credit risk on housing lending. The other is the securitisation market. While the bulk of housing debt remains on the books of authorised deposit-taking institutions, these institutions and mortgage managers alike are securitising (i.e. packaging and selling) an expanding proportion of their housing loans. Since the mid 1990s, securitised mortgages have risen from \$5 billion or 3 per cent of housing debt, to more than \$80 billion or 17 per cent of housing debt.

By distributing credit risk over a wide investor base, rather than allowing it to become concentrated on the balance sheets of a small number of financial institutions, securitisation has the potential to reduce threats to financial stability. At the same time, securitisation can introduce other forms of risk if the end-investor lacks the capacity to manage or absorb credit risk, particularly as deals become more complex. This does not appear to be a particular concern with the residential mortgage-backed securities (RMBS) market in Australia. The majority of RMBS deals are backed by prime, fully insured mortgages and, over time, their performance has typically compared favourably with the mortgages retained on the books of financial institutions. As a result, the senior tranche of RMBS issues is generally rated AAA and the subordinated tranches, which usually cover no more than five per cent of the securities issued, typically carry investment-grade ratings.

Financial intermediaries need to ensure that securitisation does not substitute other forms of risk for credit risk. APRA's prudential guidelines require authorised deposit-taking institutions to hold adequate capital against any exposures arising; to

GRAPH 12 | SECURITISATION OF RESIDENTIAL MORTGAGES Per cent of residential mortgage debt outstanding



have systems in place to identify, monitor and control the risks associated with securitisation; and to make clear disclosures to investors that there is no recourse to the institution originating the loans.

A more recent development in the dispersion of credit risk on housing lending is the emergence of “non-conforming” mortgage managers, through which borrowers who do not meet standard lending criteria can gain access to housing finance that might not otherwise be available. The non-conforming loan market in Australia is still only small in overall size (at around 5 per cent of housing loans written), but it is growing strongly. The rate of arrears on non-conforming loans appears to be much higher than the rate on housing lending by traditional lenders.

The non-conforming market does not, at this stage, raise any particular concerns from a financial stability perspective. Banks fund some of the origination and warehousing of these mortgages prior to securitisation and so carry some exposure to non-conforming lenders. Nonetheless, the exposure tends to be for a limited period and is secured against residential property. There may be a less direct impact

on financial stability via house prices. At this stage of the cycle, the growth in the non-conforming loan market is adding to demand pressure in the housing market. If economic conditions were to change, however, marginal borrowers are likely to be more vulnerable and might be expected quickly to become distressed sellers in adverse circumstances. In this way, the non-conforming loan market might become a source of additional cyclical in house prices.

Regulatory Co-operation

The RBA co-operates closely with the Australian Prudential Regulation Authority (APRA), which oversees the health of individual financial institutions, and with the Australian Securities and Investments Commission (ASIC), which has responsibility for market integrity and consumer protection across the financial system. Co-ordination between the three regulatory authorities is ensured at the highest level through the Council of Financial Regulators, which is chaired by the Governor of the RBA.

The Financial System Inquiry (Wallis Committee), whose findings were the genesis of Australia’s

current financial regulatory framework, thought that co-ordination arrangements with APRA would be bolstered by the presence on the APRA Board of two senior RBA representatives and one senior ASIC representative. However, this view was not shared by the Report of the HIH Royal Commissioner, which was released in April 2003. The Report questioned the participation of RBA and ASIC representatives on the APRA Board, and the usefulness of the Board itself. The Government has accepted the Report's recommendation that the APRA Board be replaced by an executive group, and legislation giving effect to these (and other) changes was passed by Parliament in June 2003. As a result, the RBA/APRA Co-ordination Committee, which was set up in 1998 under the RBA's chairmanship and has been meeting regularly since then, will now become the major focal point for co-operation and the sharing of information between the two agencies. The Council of Financial Regulators will also play a larger role than formerly. In particular, to ensure that co-ordination among the agencies with an interest in financial stability will continue at the highest level, the Treasurer, in June 2003 announced to Parliament that the Treasury would join the Council of Financial Regulators.

Payments System Developments

The Payments System Board of the RBA has a mandate to promote safety, efficiency and competition in the payments system in Australia and, since 2001, to promote the safety of systems that clear and settle securities transactions in Australia's wholesale financial markets.

Over recent years, the Payments System Board has been undertaking a major reform of card networks (credit cards, debit cards and automatic teller machines (ATMs)) that is intended to allow market mechanisms to operate more effectively in the retail payments system in Australia. As part of this initiative, in August 2002 the RBA, after extensive consultations, announced its reforms to credit card schemes in Australia. The reform measures involve:

- a standard on interchange fees that determines an objective, transparent and cost-based benchmark against which interchange fees in credit card schemes can be assessed (interchange fees are the fees paid to financial institutions which issue credit cards by financial institutions which provide services to merchants);
- a standard on merchant pricing which ends the restriction imposed by the international credit card schemes on merchants passing through to cardholders the costs of accepting credit cards; and
- an access regime that allows specialist credit card institutions authorised and supervised by APRA to apply to participate in credit card schemes.

The various reform measures come into effect over the course of 2003. In September 2002, MasterCard International and Visa International each filed applications in the Federal Court to have the reforms overturned. The matter was heard in May and June 2003 and judgment is expected later in 2003.

The RBA has also encouraged industry participants to reform interchange fees and access arrangements in Australia's debit card (EFTPOS) and ATM networks. The Bank believes that current arrangements have no sound basis in costs and that there is considerable scope to increase competition and efficiency in these sectors of the payments system. The ACCC has indicated that it intends to reject an industry proposal that addresses EFTPOS interchange fees but not access. The Bank encourages the industry to take up the ACCC's invitation to also address access to the EFTPOS network.

An industry proposal for a "direct charging" regime that would replace ATM interchange fees has been put out for public consultation. The RBA believes that the proposed regime will lead to more transparent pricing and greater incentives for competition in the provision of ATM services in Australia, to the benefit of ATM users, and has encouraged industry participants to finalise the proposed reform during 2003.

In the safety and stability area, the RBA has strongly supported efforts to reduce foreign

exchange settlement risk through the establishment of CLS Bank, a special-purpose bank which settles foreign exchange transactions in major currencies. CLS Bank commenced operations in September 2002, with the Australian dollar one of seven “first wave” currencies to be included. The implications of CLS Bank for the RBA’s operations are discussed in the chapter on Operations in Financial Markets.

During 2002/03, the management of Exchange Settlement (ES) accounts which banks and other eligible institutions hold at the RBA was reviewed. When real-time gross settlement (RTGS) arrangements were introduced in Australia in June 1998, it was decided that all banks would settle their RTGS transactions directly through their own ES accounts; the alternative of allowing banks to make their RTGS transactions through an agent was considered unacceptable from a risk perspective. In the light of experience since then, the Payments System Board concluded that, provided agency arrangements were limited to a relatively small proportion of the value of RTGS transactions, there would be no significant risk to financial stability if small institutions had access to another, possibly

more efficient, means of making RTGS payments. In changes announced in March 2003, banks and other institutions eligible for an ES account, whose aggregate RTGS transactions are relatively small (defined as less than 0.25 per cent of all RTGS transaction values), may now make their RTGS transactions through an agent, although banks must still maintain an ES account for use in a contingency.

As part of the Payments System Board’s broader stability mandate, the RBA has formal responsibility for ensuring that licensees of clearing and settlement facilities conduct their affairs in a way that promotes overall stability in the Australian financial system, and it has the power to set financial stability standards for such licensees. In May 2003, after a period of public consultation, the RBA determined financial stability standards that apply to licences held by entities owned by the Australian Stock Exchange and the Sydney Futures Exchange. There are two separate standards: one for central counterparties and another for securities settlement facilities.

Further information on payments system issues can be found in the Annual Reports of the Payments System Board.