# 2. The Australian Financial System

Profitability of the Australian banking system increased further in the latest half year. The outlook for profits is favourable, given that bad and doubtful debt charges are expected to continue to decline in the period ahead. Even so, non-performing asset levels remain relatively high, particularly for business loans, though they have broadly stabilised in the past year. The flooding in Queensland and other recent natural disasters are unlikely to have a material impact on banks' loan quality. The banking sector is well placed to meet the more stringent Basel III capital and liquidity requirements that will be phased in over the next few years; it has already bolstered its capital position in recent years, and the Reserve Bank of Australia (RBA) and the Australian Prudential Regulation Authority (APRA) have announced the domestic approach to meeting the liquidity requirements.

A challenge for the industry in coming years will be adjusting to a likely slower pace of credit growth compared with the previous few decades, which will limit its growth opportunities. As yet, there is little evidence that banks are significantly loosening lending standards or taking on other risks in an attempt to sustain the earlier rates of growth. The slower rate of credit growth, in combination with ongoing strength in deposit growth, has eased the pressures on wholesale funding.

The recent natural disasters will result in a significant increase in claims on general insurers. The industry is well equipped to deal with this, because it is well diversified, and has robust reinsurance arrangements and large capital buffers. While industry-wide profits will fall, profits are still expected to be supported by solid underwriting results.

## Banking System Profits

The four major Australian banks reported aggregate headline profits after tax and minority interests of $11.2 billion in their latest available half-yearly results (Table 2.1). In the corresponding period a year earlier, profits had been negatively affected by a one-off tax revaluation on these banks' New Zealand operations. Adjusting for this, profits in the latest half year were $3.7 billion higher than in the same period a year earlier. This increase was driven largely by an approximate halving in the charge for bad and doubtful debts (Graph 2.1). Net interest income and earnings from insurance and funds management operations also contributed to profit growth over the year. Gross earnings rose by 4½ per cent over the year, but this was partly offset by an 8 per cent increase in banks' operating expenses, mainly driven by technology investments and an increase in staffing expenses. The cost-to-income ratio is, however, around its lowest level on record. Consistent with the major banks' latest trading updates and profit releases, market equity analysts are forecasting further growth in profits in 2011, albeit at a slower pace than during the recent period, with ongoing rises in net interest income and further declines in bad and doubtful debt charges expected.

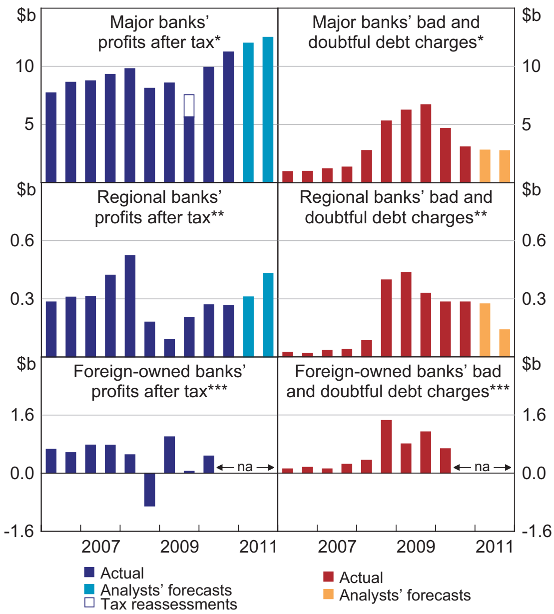
The regional Australian banks have reported more gradual increases than the major banks in their aggregate profits in recent periods, also driven by lower bad and doubtful debt charges. These banks were more severely affected by the downturn than the major banks, and though their profits, in aggregate, have recovered noticeably since 2009, they remain below pre-crisis levels. The regional

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

| | 2009<br>$billion | 2010<br>$billion | Change<br>$billion |
|---|---|---|---|
| **Income** | | | |
| Net interest income | 23.5 | 23.8 | 0.3 |
| Non-interest income | 9.8 | 11.0 | 1.2 |
| **Expenses** | | | |
| Operating expenses | 15.3 | 16.5 | 1.2 |
| Bad and doubtful debts | 6.7 | 3.1 | –3.6 |
| **Profit** | | | |
| Net profit before tax | 10.9 | 15.0 | 4.1 |
| Net profit after tax and minority interests | 7.6[(b)] | 11.2 | 3.7 |

(a) Half-year to September for ANZ, NAB and Westpac; half-year to December for CBA
(b) Excludes a one-off tax reassessment on the major banks' New Zealand operations which lowered actual profit to $5.6 billion
Sources: RBA; banks' annual and interim reports

**Graph 2.1**
**Banks' Profitability**




* 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; Deutsche Bank; Morgan Stanley; RBA; UBS Securities Australia; banks' annual and interim reports

banks' aggregate charge for bad and doubtful debts in their most recent half-yearly results was about one third lower than its peak in 2009, whereas for the major banks this charge has roughly halved from the peak. Analysts are forecasting further increases in the regional banks' profits during 2011. However, some have moderated their expectations for the banks with larger relative exposures to Queensland, partly as a result of the recent flooding and cyclone events in that state. The profitability of the foreign-owned banks in Australia has been somewhat more variable than for the Australian-owned banks in recent years, though indications are that they remained profitable during the latest half-year.

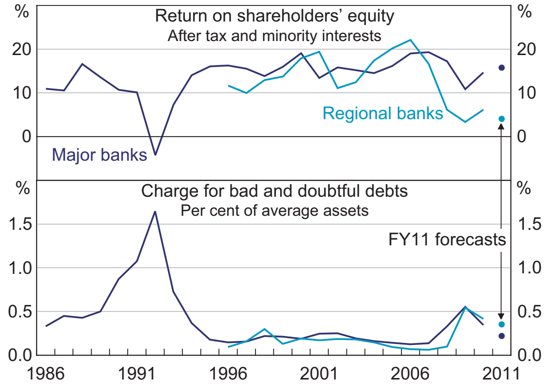
As the major banks' profits have recovered, their average return on equity has increased to near pre-crisis levels, at almost 15 per cent in 2010. Analysts are forecasting a further small rise in 2011 (Graph 2.2). The regional banks' return on equity fell by more during the crisis and remains below that of the major banks, but it has also begun to recover, reaching about 6 per cent in 2010. Analysts expect the regional banks' return on equity in 2011 to be below the level in 2010, partly reflecting the impact of the recent natural disasters.

Net interest income remains the dominant source of revenue for the Australian banks. Unlike many of the largest global banks, which had come to rely more on trading and investment income, the Australian banks have maintained their focus on traditional lending activities. The net interest margin (NIM) of the major banks has been broadly stable over the past five years or so, after an extended period when it had been declining. Within the crisis-affected period, the NIM initially declined further, though this was subsequently reversed and it has since moved within a fairly narrow range (Graph 2.3). In the latest half year, the reported NIM for the major banks' Australian operations declined by about 10 basis points. It was still 17 basis points higher than the trough in 2008, but similar to levels seen in the years preceding the crisis. The effects of the most recent round of interest rate increases (in November 2010) are not yet evident in most banks' published financial statements.[2] The NIM of the regional banks is lower than that of the major banks, and has been one factor behind the more modest improvement in their profits to date.

In recent reporting periods, the major banks' profits have also been supported by earnings from their insurance and funds management operations, which increased by 40 per cent in 2010 compared with the level in 2009, and now account for 10 per cent of their total income. This growth was driven by stronger investment returns and a pick-up in funds under management following a number of recent acquisitions. Even adjusting for acquisitions, insurance and funds management income was up strongly. Income from this source has been recovering after a period around 2008 when it had been subdued due to weakness in investment returns and slower net inflows.

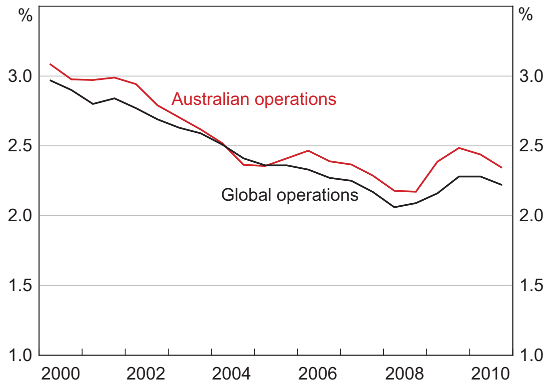
2 For more detail on developments in banks' net interest margins, see Fabbro, D and M Hack (2011), 'The Effects of Funding Costs and Risk on Banks' Lending Rates', RBA *Bulletin*, March, pp 35–41.

**Graph 2.2**
**Banks' Profitability***




* From 2006 data are on an IFRS basis; prior years are on an AGAAP basis
Sources: Citigroup; Deutsche Bank; Morgan Stanley; RBA; UBS Securities Australia; banks' annual and interim reports

**Graph 2.3**
**Major Banks' Net Interest Margins***

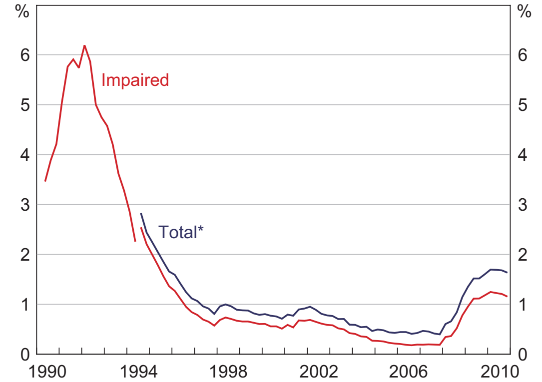



* From 2006 data are on an IFRS basis; prior years are on an AGAAP basis
Sources: RBA; banks' annual and interim reports

## Asset Quality

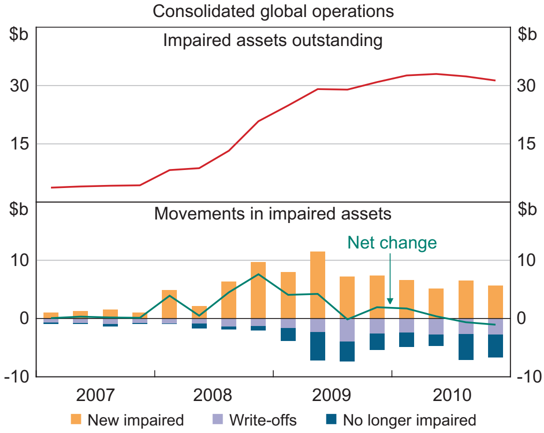
The asset quality of banks broadly stabilised in 2010, and was beginning to show slight signs of improvement towards the end of the year. The ratio of non-performing assets to total on-balance sheet assets reached 1.7 per cent in March 2010, and has since fallen slightly (Graph 2.4). The ratio for non-performing assets that are classified as impaired – consisting almost entirely of facilities that are not well-collateralised – has also edged down in the most recent quarters, to be slightly below the March 2010 level of 1.2 per cent of balance sheet

## Graph 2.4
### Banks' Non-performing Assets
Consolidated global operations, per cent of on-balance sheet assets



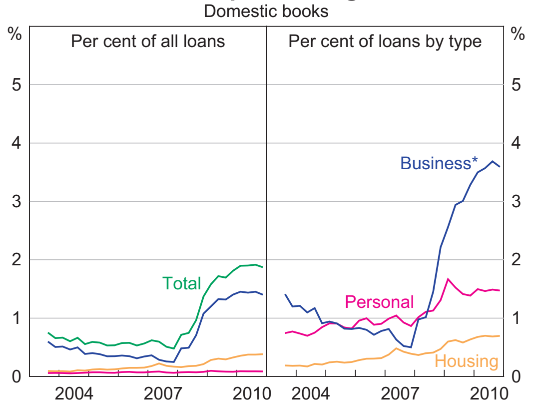

* Includes items 90+ days past-due that are well secured
Source: APRA

## 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

assets. These non-performing asset ratios are well below the peaks seen in the previous, much more severe, downturn of the early 1990s, but seem to be taking longer to begin improving in earnest. While the inflows of new impaired assets and write-offs were broadly steady through 2010, the rate at which impaired assets were 'cured' increased in the second half of the year, resulting in a slight decrease in the level of impaired assets (Graph 2.5). Assuming this trend is maintained, this turn in the non-performing assets cycle appears consistent with the sharp reductions in the charges for bad and doubtful debts seen in banks' recent profit results.

In their domestic portfolio, banks' non-performing assets were broadly steady as a percentage of all on-balance sheet loans over much of 2010, before declining slightly in the December quarter (Graph 2.6). This decline was due to a modest improvement in the business loan portfolio, though the non-performing share of this portfolio, at 3.6 per cent, remains much higher than for the housing loan portfolio. Consistent with this, business loans have continued to account for around three quarters of banks' domestic non-performing loans. The share of housing loans that are non-performing was broadly unchanged over 2010, at around 0.7 per cent. Unlike non-performing business loans, most non-performing housing loans are classified as past-due rather than impaired, indicating that they remain well collateralised – an unsurprising outcome given the house price gains in recent years (Graph 2.7).

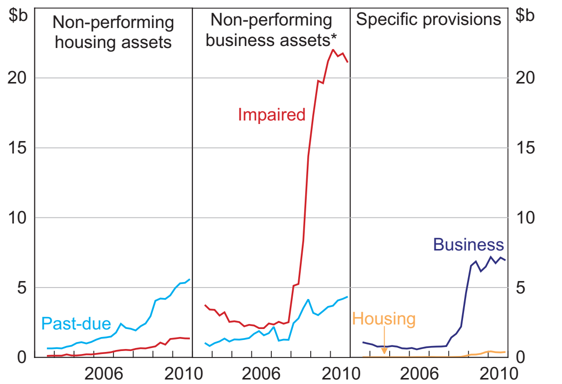
Troubled commercial property exposures have been the main contributor to the high impairment rate in banks' business loan portfolio in recent years. Promisingly, the share of commercial property exposures that is impaired fell in the December quarter 2010 for the first time in this cycle, down to 5.5 per cent from 6.2 per cent in September as banks liquidated some of their bad debts (Graph 2.8). Specific provisions held against impaired commercial property exposures also declined slightly over 2010. This modest improvement in the commercial property portfolio is consistent with the strengthening of economic activity and stabilisation of the commercial property market.

The non-performing share of the major banks' domestic loan books remains much lower than that for the smaller Australian-owned banks and foreign-owned banks (Graph 2.9). The share of non-performing assets on foreign banks' loan books has come down from a peak of 3.3 per cent in early 2009 to 2.5 per cent in December 2010, despite an outright contraction in their loan books over this period. The equivalent ratio for the smaller Australian-owned banks has increased over the past few years, reaching 3.4 per cent in December 2010, partly reflecting these banks' relatively large exposures to the commercial property sector, including property development.

Like their domestic assets, the performance of banks' overseas assets also looks to have stopped deteriorating in 2010: non-performing overseas assets fell to 2.3 per cent of banks' overseas loan books – a higher ratio than for their domestic portfolio – after reaching 3.7 per cent in mid 2009. This improvement has been underpinned by stabilising macroeconomic conditions in New Zealand, although banks remain conscious of downside risks for the New Zealand economy. In contrast, asset quality at the banks' UK operations has continued to deteriorate, albeit at a slower pace, amid a prolonged period of weak economic activity. As noted in the previous *Review*, the Australian banks have minimal exposures to the European countries whose sovereign debt sustainability and banking sector fragilities have been subject to market concerns.

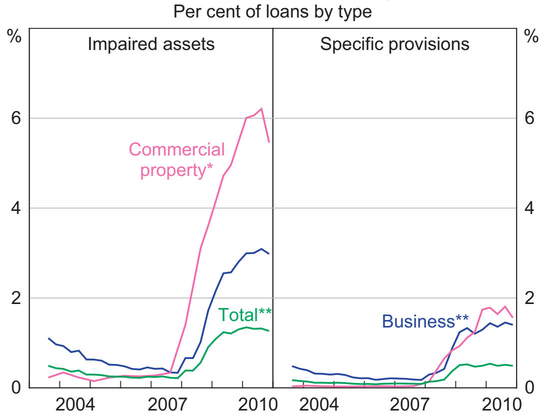
The recent natural disasters in Australia could impinge on banks' asset quality to some extent. However, the impact should be limited given that the affected regions account for a relatively small share of banks' total lending, and that most businesses should be able to resume operations fairly quickly and retain people in employment. Liaison with the major banks indicates that a large number of borrowers in flood-affected areas have

**Graph 2.7**
**Banks' Asset Quality**
Domestic books



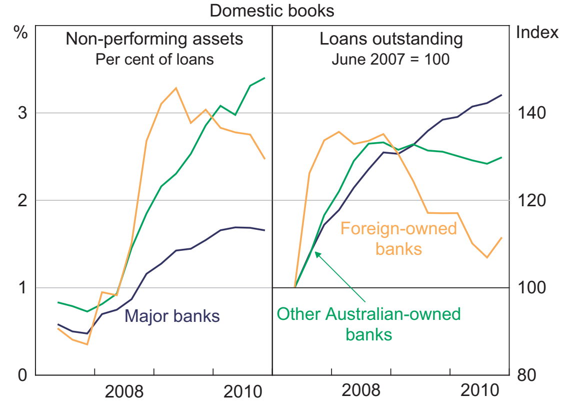

* Includes lending to financial businesses, bills and debt securities, and other non-household loans
Source: APRA

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



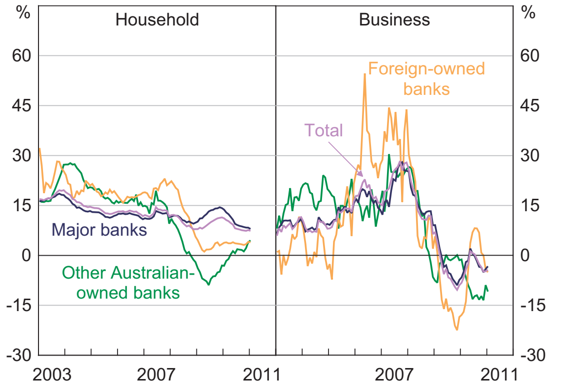

* Consolidated Australian operations; sample of 26 banks
** Domestic books; all banks; includes lending to financial businesses, bills and debt securities, and other non-household loans
Source: APRA

**Graph 2.9**
**Banks' Asset Quality and Credit**
Domestic books



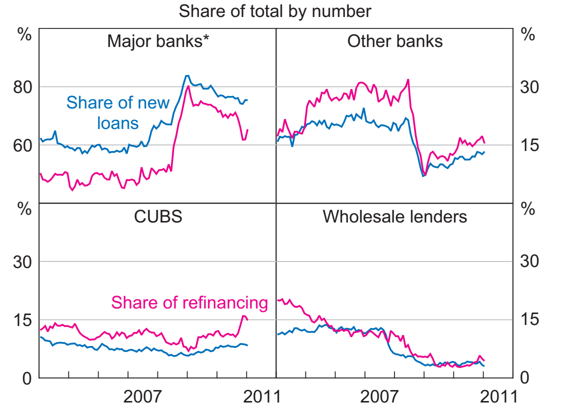

Source: APRA

## Graph 2.10
### Bank Credit Growth
Six-month-ended, annualised



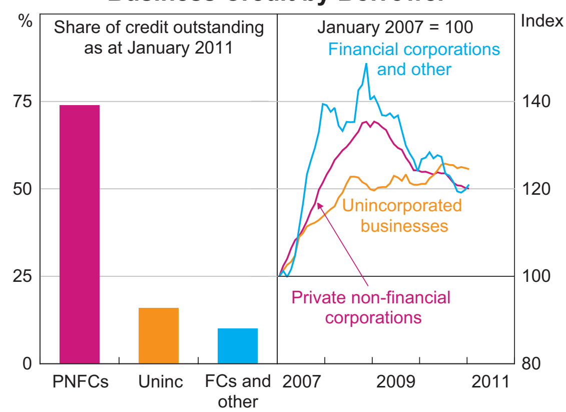

Sources: APRA; RBA

## Graph 2.11
### Owner-occupier Approvals
Share of total by number




* Includes Bankwest from December 2008
Sources: ABS; APRA; RBA

## Graph 2.12
### Business Credit by Borrower




Sources: APRA; RBA

been taking advantage of the banks' offers for hardship relief, including temporary repayment holidays. Smaller institutions whose loans are geographically concentrated in Queensland are likely to be more noticeably affected. Two regional banks have recently increased their bad debt charges in their latest half-yearly reporting periods on account of the expected flood impact.

## Lending Growth and Credit Conditions

Banks have continued to expand their domestic loan books, albeit at a slower pace than in recent years as both households and businesses have been more cautious in their borrowing. Lending to households grew by 7.4 per cent in annualised terms over the six months to January 2011, more than offsetting a 4.3 per cent contraction in banks' business lending over the same period (Graph 2.10).

Housing credit accounts for most of the household credit extended by banks, and has continued to drive its growth. Competition in home lending has intensified in the past six months as second-tier banks, credit unions and building societies (CUBS) have regained some pricing competitiveness. Reflecting this, a rising share of owner-occupier home loan approvals – particularly for refinancing – has been by CUBS and, to a lesser extent, wholesale lenders and smaller Australian banks (Graph 2.11). However, the major banks still account for around three quarters of all new owner-occupier housing loan approvals, and their home loan books are growing at a faster pace than those of the smaller institutions.

In contrast, the decline in business credit since the second half of 2010 has been evident across all lenders, including foreign-owned banks, which had increased their lending earlier in the year. The recent decline in business credit was most pronounced for larger, non-financial corporations, which are the foreign banks' main customers (Graph 2.12). Among the reasons for this could be that these borrowers are more likely to be able to access global capital markets at relatively cheaper rates, and that the recent appreciation of the Australian dollar has reduced the local-currency value of foreign-currency loans. While banks expect overall business lending to remain subdued in the near term, some expect a pick-up associated with the reconstruction effort following the recent natural disasters.

It appears unlikely that credit growth will return to the very high rates that were sustained in the pre-crisis period, since credit expansion during that period was significantly boosted by the one-time adjustment to financial deregulation and the shift to low inflation. This suggests banks' domestic growth opportunities are likely to be more limited in the future. If industry participants were to attempt to sustain earlier rates of domestic credit growth, they could be induced to take risks that may subsequently be difficult to manage. As yet, there is little sign that banks have been significantly relaxing their lending standards in a bid to stimulate credit growth. However, increasing competition in housing loans is starting to put pressure on lending standards. Some banks raised their maximum loan-to-valuation ratios in the second half of 2010 and early 2011, though this followed a period in late 2008 and early 2009 when many banks were tightening these criteria. The share of non-standard and line-of-credit loans declined as a share of new mortgage lending in late 2010 for some major banks, although this could partly reflect weaker demand for such loans.

The responsible lending requirements of the National Consumer Credit Protection regime, which came into effect for authorised deposit-taking institutions (ADIs) on 1 January 2011, should help limit any undue loosening in household lending standards. This regime, which replaced (and largely replicated) the state-based Uniform Consumer Credit Code, places a strong onus on lenders to ensure that loans are suitable for borrowers' circumstances, notably their ability to repay. Banks are now reportedly requiring both their branch and broker channels to seek additional information from potential borrowers to determine the suitability of a product; borrowers are also being required to provide more documentation in support of low-doc loans.

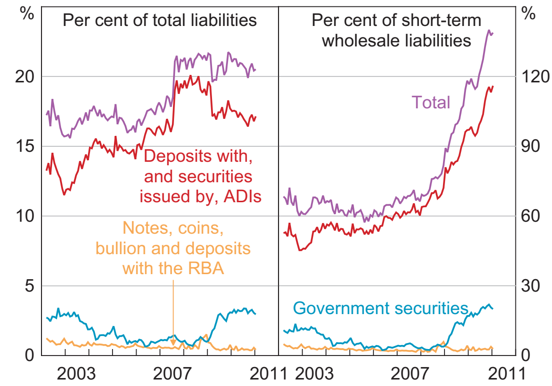
In banks' business lending, margins in the wholesale segment have reportedly narrowed in the past year, which banks attributed to softer demand, an increase in their appetite for larger deals, and the re-entry of some foreign banks into the segment. There was also some easing in non-price lending criteria for this segment. There have been no notable changes in lending criteria at the smaller end of the business loan market.

In an environment of slower domestic credit growth, banks may look to expand overseas. Recently, for example, some banks have been looking to increase their presence in the fast-growing Asian region, where there is a large pool of savings and relatively rapid credit growth in some countries. Currently, exposures to Asia (excluding Japan) account for a small share of the major banks' total offshore exposures, at around $50 billion, compared with total offshore exposures of around $650 billion. Offshore operations can offer growth and diversification opportunities, but they also raise a number of risk management and other challenges that need to be carefully handled. For example, there are challenges associated with being a new entrant to a market and having less familiarity with local market structures. The way in which banks structure their offshore investments can also have implications for how insulated the Australian operations would be from any problems emanating from overseas operations, and vice versa.

## Funding Conditions and Liquidity

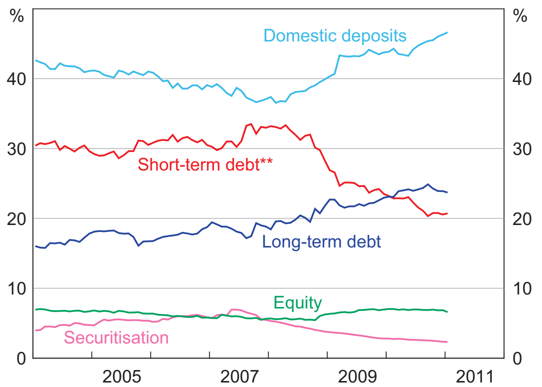
Banks continue to improve their liquidity position in the wake of the crisis. Their holdings of cash, deposits and highly marketable domestic securities as a share of their total short-term liabilities have increased strongly over recent years as the stock of short-term wholesale liabilities has continued to decline (Graph 2.13). Government securities make up a larger share of liquid assets than before the crisis, although

## Graph 2.13
### Banks' Liquid Assets*
Domestic books



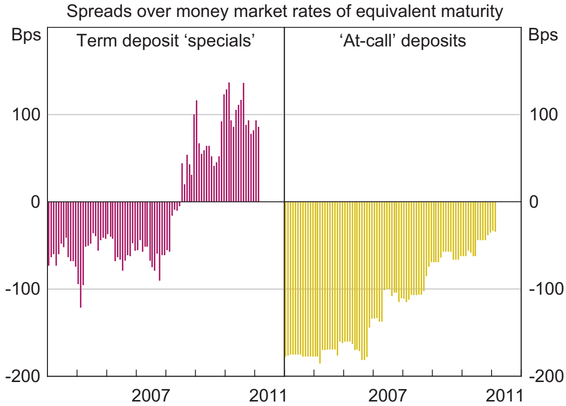

* Excludes non-resident assets
Source: APRA

## Graph 2.14
### 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 2.15
### Major Banks' Deposit Rates
Spreads over money market rates of equivalent maturity




Sources: Bloomberg; RBA

this has been steady for a number of quarters. Under the new Basel III liquidity guidelines, a smaller subset of assets will qualify as high-quality liquid assets, such that deposits and securities issued by ADIs will not be counted towards the new liquidity coverage ratio. Since Australian institutions do not have access to a sufficiently large pool of government securities, APRA and the RBA have developed an alternative approach that will meet the international standard. Under this approach, the RBA will, if required, provide banks with a committed liquidity facility secured against high-quality collateral currently eligible at the RBA for its open market operations (see the chapter on 'Developments in the Financial System Architecture' for further information).

In recent years, banks have been reducing their reliance on short-term wholesale debt because of increased market pressures and scrutiny from regulators. It has fallen from around one third of total bank funding in 2007 to around one fifth, replaced by long-term wholesale debt and deposit funding sources typically regarded as more stable (Graph 2.14). The deposit share of bank funding increased further in the second half of 2010, to 47 per cent, an increase of around 10 percentage points since early 2008.

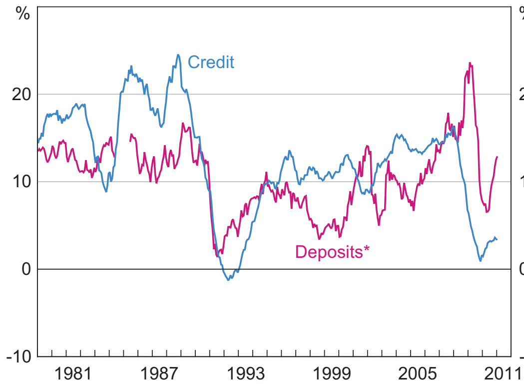
A consequence of the banks' efforts to change their funding patterns has been stronger competition in the deposit market in recent years. Deposit rates remain at or around historically high spreads to money market rates, although the intensity of competition for term deposits may have abated somewhat in the second half of 2010 as banks' funding pressures have eased; it might now be that much of the adjustment from lower-rate to higher-rate deposit accounts has run its course. Rates paid on term deposit 'specials' have narrowed a little relative to equivalent-maturity money market rates (Graph 2.15). Reflecting the relatively high rates on offer, and perhaps their perceived safety, surveys indicate that households continue to view deposits as a preferred investment option. This has been reflected in the strong rate of growth of deposits in recent years, which continues to exceed credit growth by a wide margin (Graph 2.16).

Given the attractiveness of deposit rates relative to short-term money market rates, and the current government guarantee on deposits up to $1 million through the Financial Claims Scheme, it is likely that some of the growth in deposits is due to investors in short-term wholesale instruments switching to deposits. Over the past six months, interest rates in the domestic money market have risen broadly in line with the policy rate. Spreads on three-month bank bills to the three-month overnight indexed swap (OIS) rate have traded within a range of 10 to 30 basis points (Graph 2.17).

The major Australian banks have maintained good access to local and offshore bond markets in the past six months, though they have required less of this type of funding, given the faster rate of deposit growth and still subdued credit growth. Their monthly issuance has averaged $7 billion since September 2010, compared with around $13 billion when the guarantee scheme for wholesale funding was in place. The cost of recent issuance has been largely unaffected by the ongoing sovereign debt concerns in Europe. Domestic secondary market spreads on the major banks' three-year debt, for instance, have narrowed somewhat over the past six months, and have recently been trading at around 75 basis points over swap, down from about 90 basis points in mid 2010 (Graph 2.18). For the other domestic banks, which made relatively more use of the guarantee, issuance volumes have fallen more markedly since their peaks in 2009 but are broadly in line with pre-crisis levels.

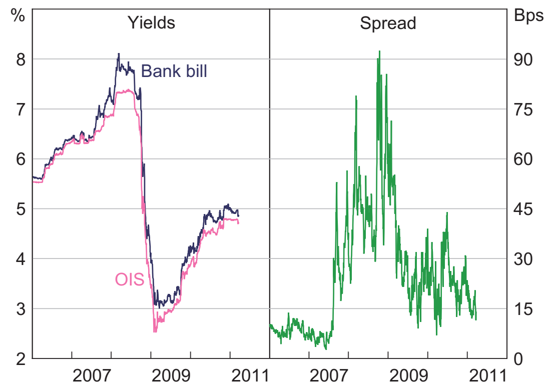
Some of the recent bond issuance has effectively been replacing maturing government-guaranteed paper, particularly that issued by the foreign-owned bank branches, which were restricted from issuing guaranteed debt with maturities longer than 15 months. Banks' total guaranteed wholesale liabilities outstanding have declined over the past six months from an average of $152 billion in August 2010 to around $128 billion

**Graph 2.16**
**Credit and Deposit Growth**
Year-ended



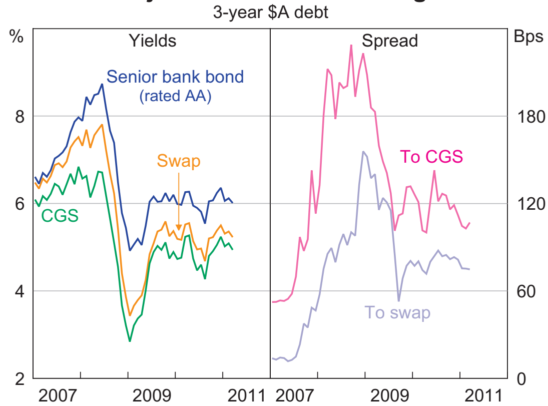

* Excludes certificates of deposit, government deposits, and foreign currency deposits; break in June 1984 due to change in reporting requirements; prior data are estimates
Source: RBA

**Graph 2.17**
**3-month Interest Rates**



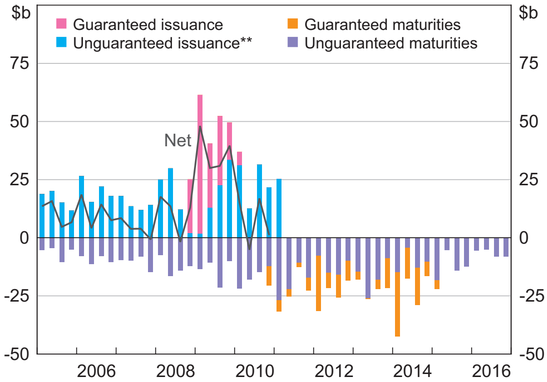

Sources: RBA; Tullett Prebon (Australia) Pty Ltd

**Graph 2.18**
**Major Banks' Bond Pricing**
3-year $A debt



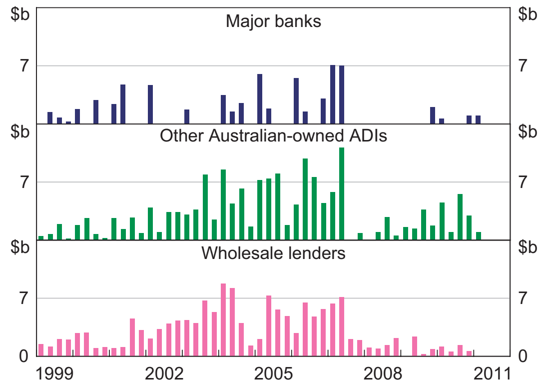

Sources: RBA; UBS AG, Australia Branch

## Graph 2.19
### Banks' Bond Issuance and Maturities*
A$ equivalent



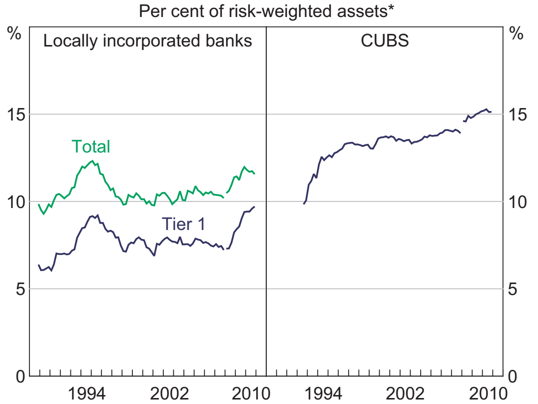

* Excludes 12-15 month paper, considered as 'short-term' under the Australian Government Guarantee Scheme
** March 2011 is quarter-to-date
Source: RBA

## Graph 2.20
### RMBS Issuance*




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

## Graph 2.21
### Capital Ratios
Per cent of risk-weighted assets*




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

in February 2011. Some banks have also recently sought to repurchase government-guaranteed bonds that had around one year left before maturity and replace them with unsecured, longer-term funding. These buy-back offers have had a variable take-up, however, partly because some investors in guaranteed bonds have 'hold to maturity' mandates.

The flow of bank bond maturities (both guaranteed and unguaranteed) is expected to be broadly stable for the next few years (Graph 2.19). Liaison with the major banks indicates that they anticipate being able to replace their guaranteed debt in these years and are generally ahead of their funding plans for the current year.

Issuance of residential mortgage-backed securities (RMBS) picked up in the second half of 2010, particularly from the smaller ADIs that have traditionally relied the most on this form of funding (Graph 2.20). Confidence in this market appears to be gradually returning, and primary market pricing has improved a little since the previous *Review*. The Australian Office of Financial Management continues to support the market, having purchased about one third of RMBS issuance during the second half of 2010. Losses from prime RMBS (after proceeds from property sales) continue to be fully covered by credit enhancements such as lenders' mortgage insurance (LMI), and no losses have been borne by investors in a rated tranche of an Australian RMBS.

## Capital and Financial Markets' Assessment

The Australian banking system remains well capitalised, with the aggregate Tier 1 capital ratio increasing by 0.3 percentage points over the second half of 2010, to 9.7 per cent (Graph 2.21). After issuing large amounts of new equity in 2008 and 2009, most of the recent growth in banks' Tier 1 capital has been through retained earnings and dividend reinvestment plans. Lower tranches of capital have continued to mature over the past year; banks have not been rolling over their term subordinated debt, as markets and regulators are now placing less emphasis on Tier 2 capital. CUBS maintained their higher capital ratios, with an aggregate Tier 1 capital ratio of around 15 per cent in December 2010.

Contributing to the rise in the banks' aggregate Tier 1 capital ratio in the second half of 2010 was a 1.2 per cent fall in risk-weighted assets. This reflects the ongoing shift in the composition of banks' loan portfolios towards housing loans, which typically attract much lower risk weights than business and personal loans. For the major banks, which are authorised by APRA to use their own internal models to derive risk weights, the fall in risk-weighted assets also reflects a slight decline in the risk weights they apply to different loan portfolios (Graph 2.22).

As a result of the strengthening of their capital levels in recent years, Australian banks are well placed to meet the more stringent Basel III capital requirements that are being phased in over the next decade or so. Their starting positions were also more favourable than for banks in some other countries because APRA applies Basel II standards more conservatively in its existing capital rules.

Australian bank share prices have generally traded within narrow ranges for much of the past year (Graph 2.23). Private-sector equity analysts have downgraded their profit forecasts for two of the regional banks that have the largest relative exposures to Queensland – by around 15 per cent since the start of the year – in light of the recent natural disasters. Accordingly, the share prices of the regional banks have underperformed the broader market since November, while those for the major banks have been similar to the broader market over this period.

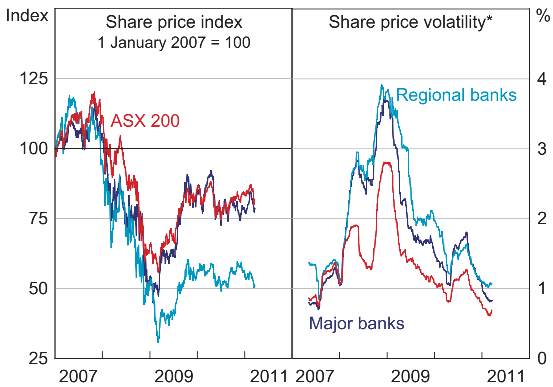
Banks' share price volatility has continued to decline since around the middle of 2010, as markets became less concerned that European sovereign debt problems could spill over to other regions' banking systems. Australian banks' credit default swap (CDS) premia have been largely unchanged since September 2010 and are generally a little below the CDS premia for large banks overseas.

Market-based valuation measures for banks have been in the vicinity of their long-term averages since mid 2010 (Graph 2.24). The forward price-to-

**Graph 2.22**
**Major Banks' Credit Risk-weights**
Consolidated global banking group*

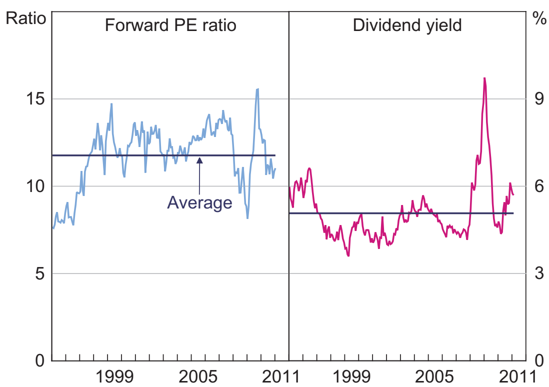

* On-balance sheet portfolios assessed under the Internal Ratings-based approach only
** Loans to households and small businesses that are secured by residential mortgages
Source: APRA

**Graph 2.23**
**Financial Market Indicators**




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

**Graph 2.24**
**Bank Valuation Indicators**




Source: Thomson Reuters

earnings (PE) ratio has been little changed since late 2010 and the dividend yield – the amount paid in dividends relative to the share price – has been rising since mid 2010 as improved profitability has allowed banks to increase their dividend payments.

The Australian banks continue to have strong credit ratings. All four major banks remain AA-rated by Standard & Poor's (S&P), while the other Australian banks are distributed between S&P's upper-medium and lower-medium investment grade ratings. There have been few changes to Australian bank credit ratings in the past six months. However, Moody's has placed the major banks on negative watch for a possible downgrade from their current Aa1 rating, its second highest rating available. S&P are conducting a more general review of their rating methodology which will result in a reassessment of their global bank ratings later in the year.

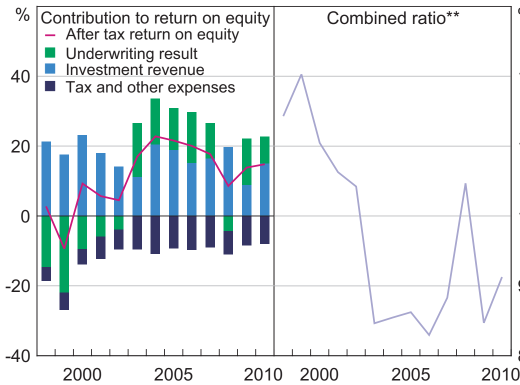
## General Insurance

Since the previous *Review*, a number of natural disasters in Australia and New Zealand have focused attention on the Australian general insurance industry. Early indications are that some of these events, notably the floods and Cyclone Yasi in Queensland, will generate total claims on Australian insurers that are high by the standards of previous Australian natural disasters. To date, there have been about 145 000 claims lodged with insurers resulting from the recent Australian natural disasters, and it has been estimated that the final value of all claims from these events could reach around $4 billion (before recoveries from reinsurance).

Despite the magnitude of the recent events, the general insurance industry is well placed to cope with the claims. An important mitigating factor for the overall claims exposure of insurers is their reinsurance arrangements, which will cap the net amount they have to pay on claims arising from these events (see 'Box B: Reinsurance and the Australian General Insurance Industry'). Even so, claims on insurers will be higher in the current financial year, which will reduce industry profits.

Strong profitability in the previous year strengthened the industry's ability to cope with the recent major claims events. In the latest available data, which only include the impact of events through end December 2010, general insurers reported aggregate post-tax profits of $4.4 billion in 2010. This represented a return on equity of around 15 per cent, which is up from 9 per cent in 2008, but still a little below the average of the five years prior to that (Graph 2.25).

**Graph 2.25**
**General Insurers' Performance***
Calendar year



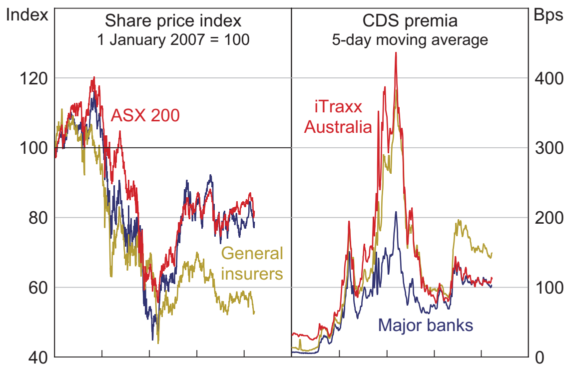

* Change in prudential reporting requirements in June 2010
** Claims and underwriting expenses as a per cent of net premium revenue
Source: APRA

In 2010, a pick-up in investment earnings offset a somewhat weaker underwriting result. Claims were boosted by the Melbourne and Perth storms, which each resulted in around $1 billion in claims, and the impact of the central Queensland floods in December. Aggregate claims paid (net of reinsurance and other recoveries) grew by 16 per cent in 2010, to $17 billion. At the same time, premium revenue grew by 4 per cent, similar to the average growth rate over the previous five years. This rise reflected both increases in premium rates, including for home and contents lines, and a pick-up in the number of policies written. The industry's weaker underwriting result in 2010 was reflected in the aggregate combined ratio – claims and underwriting expenses relative to net premium revenue – rising by 7 percentage points, to 91 per cent.

Consistent with the solid profits over recent years, the general insurance industry remains well capitalised. As at December 2010, the industry held capital equivalent to around twice the regulatory requirement. APRA is in the process of revising general insurers' capital standards, with the aim of making them more risk-sensitive and similar to the three-pillar framework currently in place for banks. The revised standards are due to be implemented in 2013.

S&P has recently reaffirmed the credit ratings of the largest Australian insurers, which are all A+ or higher, noting the high levels of capital and solid profitability as supportive factors. The share prices of the large insurers have slightly underperformed the broader share market since mid December, however (Graph 2.26). Insurers' CDS premia have been broadly stable over the past five months, and remain below the levels seen in mid 2010.

**Graph 2.26**
**Financial Market Indicators**




Sources: Bloomberg; JPMorgan; RBA

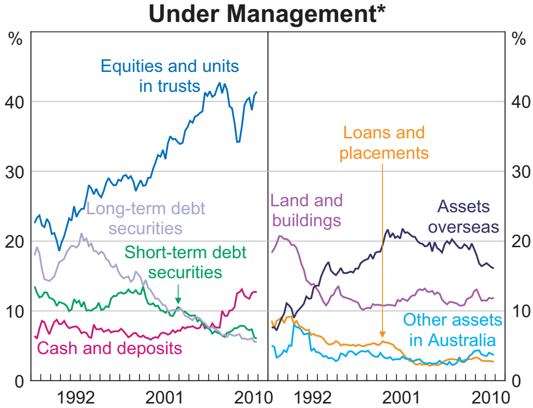
Operating conditions for the two largest providers of LMI in Australia – QBE and Genworth – appear to have improved. Both reported solid profits and a decline in claim ratios over the past year. Moreover, the LMIs are likely to be little affected by the recent Australian natural disasters given these events are unlikely to have a significant effect on Australian banks' asset quality. The Australian mortgage insurance operations of QBE and Genworth continue to be rated highly, with both rated AA- by S&P. However, after putting Genworth's US parent on review for possible downgrade following losses in its US mortgage insurance business, Moody's has also recently put Genworth's higher-rated Australian subsidiary on review. This review will consider the degree to which Genworth Australia's financial position and business operations may be affected by weakness at its parent.

## Managed Funds

The total consolidated assets of domestic funds management institutions grew by 9 per cent in annualised terms over the six months to December 2010, compared with an average annual growth rate of 7 per cent over the past decade (Table 2.2). Asset growth was strongest at superannuation funds, which now account for 67 per cent of managed funds' assets. Assets also increased at life insurers over the December 2010 half year, while assets held by other major fund manager types fell.

The value of funds management institutions' holdings of equities and units in trusts increased considerably over the December 2010 half year, benefiting from improved market returns over the period (Graph 2.27). This was partly offset by falls in holdings of short- and long-term debt securities.

**Graph 2.27**
**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

## Table 2.2: Assets of Domestic Funds Management Institutions[(a)]

December 2010

| | Level | Share of total | Six-month-ended annualised change | |
|---|---|---|---|---|
| | | | Jun 10 | Dec 10 |
| | $billion | Per cent | Per cent | Per cent |
| **Superannuation funds (consolidated)** | **947** | **67** | **2.1** | **15.5** |
| Superannuation funds (unconsolidated) | 1 110 | | 1.6 | 17.2 |
| *of which*: | | | | |
| Equities | 365 | 33 | –7.3 | 34.3 |
| Assets overseas | 180 | 16 | 0.3 | 10.5 |
| Units in trust | 177 | 16 | –4.4 | 25.7 |
| Cash and deposits | 160 | 14 | 12.7 | 13.5 |
| Land and buildings | 79 | 7 | 14.0 | 10.3 |
| Short-term securities | 54 | 5 | –0.9 | –8.3 |
| Long-term securities | 52 | 5 | 16.6 | –9.8 |
| Loans and placements | 11 | 1 | 8.6 | 10.9 |
| Other assets in Australia[(b)] | 33 | 3 | 42.9 | –12.5 |
| **Life insurers (consolidated)[(c)]** | **187** | **13** | **–8.3** | **10.6** |
| **Public unit trusts (consolidated)** | **251** | **18** | **–1.8** | **–1.7** |
| Public unit trusts (unconsolidated) | 286 | | –0.1 | 0.6 |
| *of which*: | | | | |
| Listed property trusts | 121 | 42 | 1.2 | 3.6 |
| Unlisted equity trusts | 97 | 34 | 2.3 | 5.3 |
| Listed equity trusts | 39 | 14 | –5.3 | –8.1 |
| Other trusts | 30 | 10 | –5.1 | –12.4 |
| **Other managed funds (consolidated)[(d)]** | **38** | **3** | **–11.2** | **–39.9** |
| **Total (consolidated)** | **1 423** | **100** | **–0.6** | **9.3** |
| *of which*: | | | | |
| All superannuation assets[(e)] | 1 113 | | 0.3 | 14.7 |

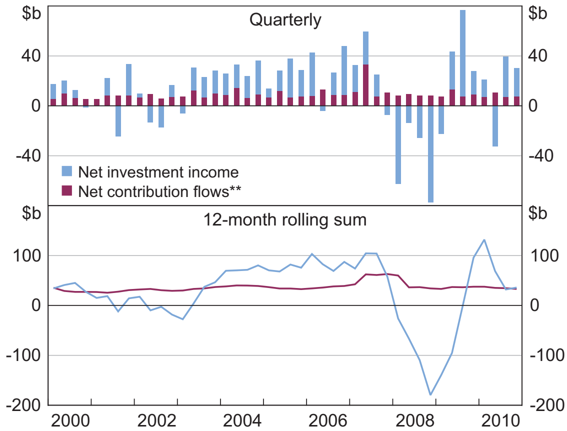
(a) Excluding funds sourced from overseas, government, other trusts, general insurance and 'other' sources
(b) Includes non-financial assets
(c) Includes superannuation funds held in statutory funds of life insurers
(d) Cash management trusts, common funds and friendly societies
(e) Superannuation funds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

Consolidated assets of superannuation funds increased at an annualised rate of 16 per cent over the six months to December 2010, to $947 billion. This growth was much stronger than the 2 per cent annualised growth recorded over the previous six-month period. To a large extent, this occurred because around 50 per cent of superannuation assets are held in equities and units in trusts, which recorded strong valuation gains over the half year. Accordingly, the net investment income of superannuation funds was well above recent averages, at around $55 billion for the December 2010 half (Graph 2.28). This compares with an average of around $15 billion per half year for the past decade. Net inflows to superannuation funds remained broadly steady at rates similar to those seen in recent years.

Life insurers' consolidated assets increased at an annualised rate of 11 per cent over the

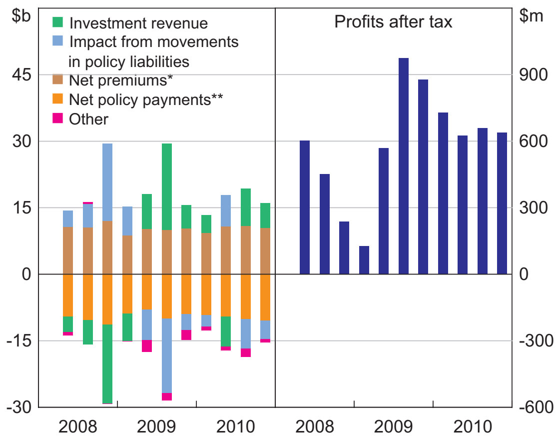
December 2010 half year, with much of the growth attributable to superannuation business, which account for around 90 per cent of life insurers' assets. Like superannuation funds, a large portion of life insurers' assets are in the form of equities and units in trusts. As such, life insurers reported strong mark-to-market gains on their investments over the half year, recording around $14 billion in investment income (Graph 2.29). Life insurers recorded a total post-tax profit of $1.3 billion in the six months to December 2010, which was similar to the previous half year. Net premiums and net policy payments remained fairly stable over the year to December 2010.

**Graph 2.28**
**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 2.29**
**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

The profitability of life insurers has contributed to their solid capital position in recent years, with the industry holding around 1.5 times the regulatory minimum at December 2010. APRA is in the process of revising life insurers' capital standards, which will better align their capital framework with those of general insurers and ADIs, and make it more risk sensitive.

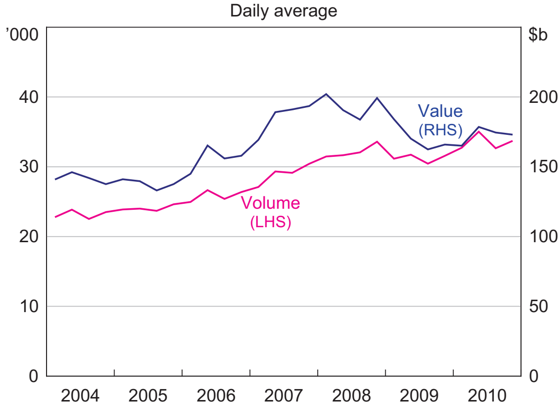
Outside of superannuation funds and life offices, the bulk of assets under management in Australia are invested in public unit trusts. On a consolidated basis, assets of public unit trusts fell at an annualised rate of around 2 per cent in the December 2010 half year. This was driven by lower asset holdings at the two smallest constituents: listed equity trusts and other trusts. Balances in listed property trusts and unlisted equity trusts rose over the half.

## Market Infrastructure

Australia's payments system infrastructure has continued to perform well over the past six months, in an environment of more settled market conditions. Over this period, the number and value of high-value interbank payments have been relatively stable. Activity in foreign exchange transactions involving the Australian dollar has continued to increase in line with market-wide trends, with settlement of this larger volume of transactions proceeding smoothly. Lower volatility in financial markets has led to lower risk for central counterparties, although these entities have maintained a conservative approach to their risk management in light of uncertainty in markets offshore.

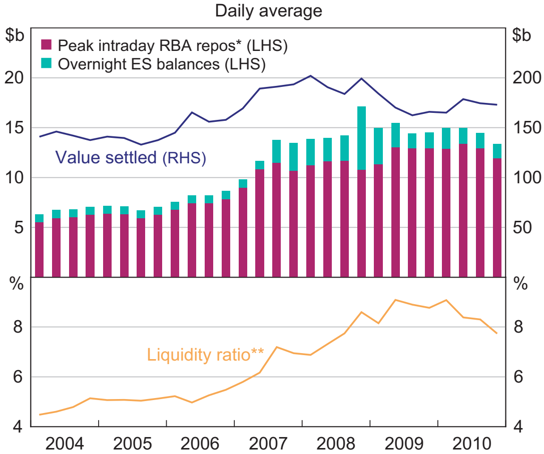
In Australia, high-value payment transactions settle on a real-time gross settlement (RTGS) basis through the Reserve Bank Information and Transfer System (RITS). In recent months, the number of transactions settled in this system has been close to its historical peak level; during the December quarter 2010, about 34 000 transactions were settled on average each day (Graph 2.30). This is about the same as at the peak in activity before the onset of the financial turmoil, and about 4 per cent below the most recent peak. By contrast, the value of RITS transactions was 14 per cent lower in the December quarter than its historical quarterly peak, averaging around $173 billion per day.

**Graph 2.30**
**RITS Settled Payments**
Daily average




Source: RBA

**Graph 2.31**
**RITS Peak Liquidity**
Daily average




* Maximum intraday cumulative balance of first leg RBA repos less second leg RBA repos
** Peak liquidity as a share of value settled
Source: RBA

RTGS transactions settle across Exchange Settlement Accounts (ESAs) held at the RBA; the availability of sufficient liquidity is critical in ensuring efficient settlement of payments between ESA holders. One way to measure this is to observe the peak in daily liquidity, measured as the sum of balances held overnight in ESAs and the maximum level of intraday repurchase transactions (repos) undertaken with the RBA. Peak daily liquidity was $13.4 billion in the December quarter, which is the lowest level since the second quarter of 2007 (Graph 2.31). The liquidity ratio, measured as peak liquidity over the total value settled in the system, has fallen recently, reflecting both relatively subdued payments values along with a decline in RITS participants' demand for precautionary settlement funds. Nevertheless, this measure of liquidity remains reasonably high when compared with the longer run.

In addition to RTGS transactions, RITS settles batches of net interbank obligations. The average daily value settled in the 9.00 am batch, which includes obligations arising from the clearing of low-value retail payments (such as cheques, debit and credit card transactions and direct entry), increased by 12 per cent in the December quarter 2010 compared with the previous quarter (Graph 2.32). Over the same period, the average daily value of obligations settled in the ASX's CHESS (Clearing House Electronic Sub-register System) batch increased by more than 30 per cent. Although the value settled in the CHESS batch is often strongly influenced by stock market turnover (by value), the most recent increase in the value of CHESS batch settlements looks to have coincided with significant growth in capital raisings during the last quarter of 2010.

Continuous Linked Settlement (CLS) Bank provides a mechanism for settling foreign exchange transactions on a payment-versus-payment basis, thereby eliminating foreign exchange settlement risk. CLS Bank currently settles transactions in 17 currencies, including the Australian dollar. Around $215 billion of transactions involving the Australian dollar were settled each day on average during January 2011 (Graph 2.33). This is down somewhat from the peak in activity that coincided with the European sovereign debt concerns in the middle of 2010, but remains high in historical terms. While notably volatile in recent months, activity in Australian dollar transactions closely follows the trend across all currencies.

CLS Bank is chartered in the United States and regulated and supervised by the Federal Reserve System. Co-operative oversight by the central banks of the currencies that settle in CLS is, however, conducted through the CLS Oversight Committee, which is co-ordinated by the Federal Reserve and of which the RBA is a member. Members of the Oversight Committee receive regular communications from CLS Bank, which allows them to monitor the operation of CLS Bank's settlement service. There were no serious disruptions to the settlement service in the past six months.

The central counterparties operated by the Australian Securities Exchange, ASX Clear and ASX Clear (Futures), play a critical role in Australia's financial markets. Through a process known as novation, these entities interpose themselves between trades on Australia's major equity and derivatives markets – effectively becoming the buyer to every seller and seller to every buyer. While this reduces risk arising from bilateral exposures between participants, it also leads to the concentration of default risk within the central counterparties, which they manage through a range of risk controls. The robustness of these controls is examined by the RBA in its annual assessment of each central counterparty's compliance with the RBA's *Financial Stability Standard for Central Counterparties*.[3]

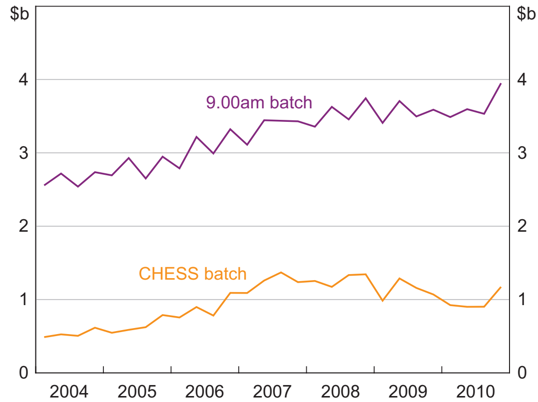
Generally benign conditions in the Australian market in the second half of 2010 meant that ASX Clear and ASX Clear (Futures) faced few challenges to their risk controls. Trading activity in equities and derivatives eased following strong growth in the first part of the year, while sharemarket volatility declined.

3 The most recent assessment is RBA (2010), '2009/10 Assessment of Clearing and Settlement Facilities in Australia', October.

**Graph 2.32**

**RITS Batch Settlement**

Daily average

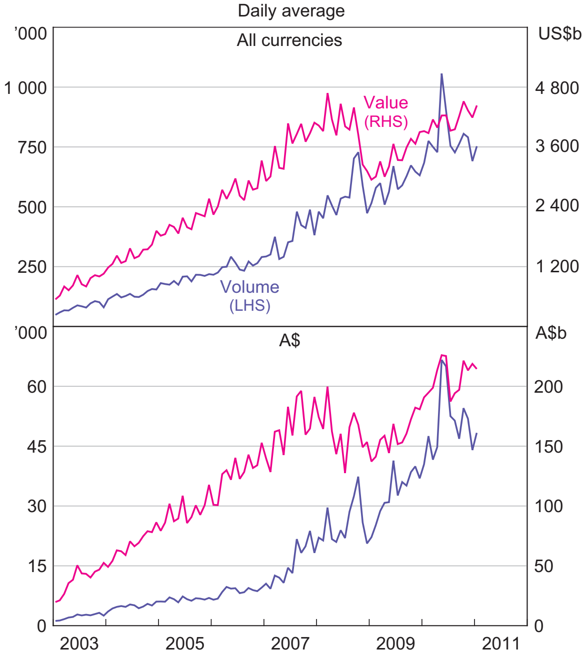



Source: RBA

**Graph 2.33**

**CLS Settlement**

Daily average

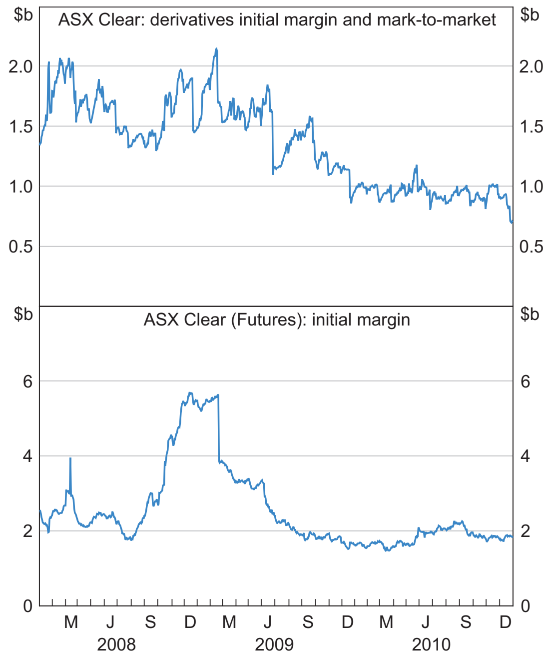



Source: CLS Bank

A consequence of lower volatility was that both central counterparties made fewer intraday margin calls to their participants; these calls are made when intraday price movements erode the margin posted against derivatives positions.

Even though conditions in the domestic market were fairly settled, the central counterparties maintained a conservative approach to risk management during the period. This stance was taken in light of remaining uncertainty in markets globally, which suggested the possibility of a return to volatility in the Australian market. The conservative approach taken was evident primarily in the decision by ASX Clear (Futures) not to decrease initial margin rates for any of the major derivative contracts until late in the year, despite the less volatile conditions (Graph 2.34). At ASX Clear, margin collected against derivatives positions (mainly in equity derivatives) was broadly flat over the second half, before falling away at the end of the year as traders delayed rolling over positions until after the holiday period.

**Graph 2.34**
**Margins**




Source: ASX

Outside of the central payments system infrastructure, the recent major floods in the eastern states saw some instances of temporary bank branch and ATM closures and minor disruptions to the distribution of cash and the processing of cheques. Through the use of contingency procedures, industry workarounds and some ADIs accessing their backup sites, the disruptions were minimised and payments processing typically operated at full or close to full capacity. The RBA, in co-operation with industry bodies and other regulators, closely monitored the situation and assisted in co-ordinating the industry response. The recent experience of processing disruptions at some major banks, unrelated to the floods, highlights the need for these contingency procedures, as well as for adequate investment in the necessary IT infrastructure.