Surveillance of the Financial System

The Reserve Bank has a general responsibility to safeguard the stability of the Australian financial system. This mandate was reconfirmed by the Government when it introduced landmark changes to Australia's financial regulatory structure, which came into effect from 1 July 1998. These changes included the transfer of responsibility for the supervision of banks in Australia to a new integrated regulator, the Australian Prudential Regulation Authority (APRA), and the establishment of the Payments System Board within the Bank, with the backing of strong regulatory powers.

The bedding-down of the new financial regulatory framework during 1998/99 coincided with a difficult global environment, as the Asian economic and financial crisis engulfed other regions, and with bouts of turmoil in international financial markets. Buoyed by the ongoing strength of the domestic economy, however, the Australian financial system continued to perform resiliently and, as the year ended, there were no discernible threats to system stability.

The Reserve Bank's responsibility for system stability

The Reserve Bank no longer has an obligation to protect the interests of bank depositors nor does it have powers to direct the affairs of an individual financial institution; its previous powers in this area have passed, in expanded form, to APRA. The new financial regulatory structure, instead, allows the Reserve Bank to concentrate its attentions fully on the overall stability of the financial system. Financial instability and the associated disruption to the normal processes of financial intermediation can impose severe costs on an economy. This has been illustrated all too graphically by recent events in Asia, but industrial countries have not been immune. Preventing financial instability is therefore an important goal of public policy. The Bank's objective is to ensure that financial disturbances in *any* part of the financial system do not ultimately threaten the health of the economy. The Bank can contribute, in various ways, to building the foundations for a stable financial system and it can also help limit the potentially adverse effects of financial disturbances if they occur.

Financial stability is built on a number of foundations. The first is a low-inflation environment. Such an environment reduces distortions in the financial sector and discourages asset speculation financed by borrowings. On this score, Australia's excellent inflation performance in recent years is paying valuable dividends. However, low inflation itself does not guarantee financial stability, as Japan's experience in the late 1980s confirms. Excessive credit growth and asset-price bubbles can still occur, putting at risk the financial system and the performance of the economy more broadly. In setting monetary policy, the

Reserve Bank needs to be cognisant of any vulnerabilities of these types in the financial system.

A second foundation is a safe and robust payments system – one in which difficulties in a single financial institution do not cascade through the financial system. Reflecting this, the Reserve Bank has been given formal responsibility for the safety and efficiency of the Australian payments system, a responsibility exercised by the Payments System Board. Australia's real-time gross settlement (RTGS) system, which has now successfully completed its first full year of operation, plays a vital role in this regard by eliminating settlement risk for those high-value payments between financial institutions which are at the core of the payments system.

A third foundation for financial stability is efficient and smoothly functioning financial markets. As recent events in Asia and elsewhere have confirmed, financial instability arising from disturbances in financial markets can be as costly as instability caused by financial institutions in distress. The Reserve Bank closely monitors developments in, and the integrity of, the major financial markets in Australia – namely, the money, bond and foreign exchange markets – which are essential to the conduct of monetary policy and relevant for financial stability more generally. The Bank is also currently responsible for authorising institutions to deal in foreign exchange but this responsibility is intended to pass to the Australian Securities and Investments Commission (ASIC).

A sound framework of prudential supervision is also, of course, a critical foundation for financial stability. Supervision is now the immediate responsibility of APRA. However, where it sees the need, the Reserve Bank also seeks to influence the nature of the regulatory environment, both domestically and internationally. The Bank's involvement in financial markets and its broad macro-economic responsibilities give it a unique perspective. Over the past year, the Bank has participated in numerous international meetings and working groups on reform of the international financial architecture – described in more detail in "Reform of the International Financial System." In the various fora the Bank has been a strong advocate for better disclosure, particularly by highly leveraged institutions. Through improved disclosure, counterparties and regulators are better able to assess accurately the risks that various institutions pose for the stability and integrity of financial markets.

In addition to the contribution it can make in a preventative way, the Reserve Bank also has a key role to play in responding to financial disturbances if they occur. On occasions, such disturbances might first reveal themselves in the payments system, in the form of liquidity pressures on a particular institution. Australia's RTGS system has been designed to allow institutions and the Reserve Bank a good deal of scope to deal with such pressures. The mechanism by which "queued" payments are tested and settled is specifically designed to minimise liquidity needs and reduce the possibility of liquidity pressures facing one institution being transmitted to others. The Bank monitors the system's operation in real time and ensures that market participants are aware of building pressures. Through its domestic market operations, the Bank can quickly provide increased liquidity to the market to allow it to negotiate periods of stress; RTGS operating hours can also be extended to allow participants to complete daily payments. These safety devices were effectively tested on several occasions over the past year, not because of financial pressures but because operational problems in particular institutions caused some payments to be temporarily delayed.

More broadly, and unlike the other regulatory agencies in Australia, the Reserve Bank is able to use its balance sheet to provide emergency liquidity support to the financial system. It would seek to do so, wherever possible, by making funds available to the market as a whole through its normal domestic market operations; the market would then be responsible for allocating funds to individual institutions. The Reserve Bank could also lend directly to a fundamentally sound institution in liquidity difficulties; it would do so, however, only if it were of the view that the failure of the institution to make its payments could have serious implications for the rest of the financial system, and there was a need to act expeditiously. In principle, a lender-of-last-resort loan could be made to any institution supervised by APRA. The Bank does not see its balance sheet as available to support insolvent institutions.

Australia's new financial regulatory structure calls for close and effective co-operation between the Reserve Bank, with its mandate for financial system stability, and APRA, which has responsibility for supervising individual financial institutions. A number of mechanisms have been put into place to achieve this. The Reserve Bank has two representatives on the APRA Board, and APRA has a representative on the Payments System Board. The two institutions have also signed, and published, a Memorandum of Understanding, covering such matters as information sharing, prompt notification of regulatory decisions that have an impact on the other institution's responsibilities, and arrangements for dealing with financial crises. In addition, a Reserve Bank/APRA Co-ordination Committee, chaired by the Bank, has been established to ensure that the co-ordination arrangements work smoothly.

An early priority for the Co-ordination Committee has been to establish a framework for information sharing. For its part, the Reserve Bank is providing APRA with relevant data from the payments system and regular briefings on the Australian economy. In turn, APRA is supplying the Bank with data needed to construct the monetary and credit aggregates, as well as prudential data in aggregate form which are used to assess developments in the financial system. In the normal course, the Reserve Bank will not receive confidential prudential data on individual institutions. The Co-ordination Committee has also been examining how Australia can contribute to the widely used International Banking Statistics compiled by the Bank for International Settlements (BIS).

The International Conference of Banking Supervisors, jointly hosted by the Reserve Bank and APRA in Sydney in October 1998: (left to right) William McDonough, President of the Federal Reserve Bank of New York and Chairman of the Basel Committee on Banking Supervision; The Hon Peter Costello, Federal Treasurer; Graeme Thompson, Chief Executive of the APRA; and Governor Ian Macfarlane.

Australia's participation in this collection is in line with the recommendations of the Prime Minister's Task Force on International Financial Reform. Other issues discussed by the Co-ordination Committee over the past year include Australian banks' exposures to highly leveraged institutions; the impact of financial market turbulence in late 1998 on banks' willingness to lend; progress in reform of the Basel capital arrangements; and the financial system's preparations for the Year 2000.

During the year, the Reserve Bank participated in a small number of APRA's regular on-site reviews of supervised institutions as a way of staying abreast of supervisory processes and risk management practices in financial institutions. The schedule of visits is designed to ensure that the Bank's understanding of the operations of different types of financial institutions remains up to date.

The Reserve Bank and APRA, together with ASIC, are members of the Council of Financial Regulators; the Governor acts as chair. This umbrella body provides a high-level forum for co-operation and collaboration among its members, as a means of contributing to the efficiency and effectiveness of regulation. A particular focus of the Council over the past year has been the Year 2000 issue (see "The Reserve Bank's Role in Preparations for the Year 2000").

In October, the Reserve Bank and APRA jointly hosted in Sydney the biennial International Conference of Banking Supervisors, held under the auspices of the Basel Committee on Banking Supervision. The Bank covered the cost of Australia's contribution to the Conference. The Conference, which brought together banking supervisory authorities from about 120 countries, focused on the Core Principles for Effective Banking Supervision (as published by the Basel Committee) and on the various operational risks facing banks.

The Australian financial system

Over the course of 1998/99, the Australian financial system faced a number of developments which, taken together, might have been sources of potential pressures on system stability. These were the continuing economic and financial problems in Asia, the turmoil in world financial markets following Russia's moratorium on foreign debt repayments and the near-collapse of Long-Term Capital Management. The Australian financial system has coped well with these developments and remains in strong condition, underpinned by the robust growth of the Australian economy.

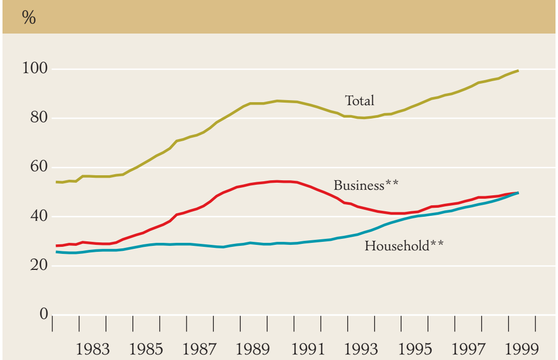
Notwithstanding Australia's close geographical and economic ties with the Asian region, international confidence in the Australian financial system has never waned throughout the Asian crisis. The credit ratings of the major Australian banks, even those with larger exposures to Asia, have been maintained. During the early stages of the crisis there were concerns that Australian banks could be adversely affected, either through their direct exposures to borrowers in Asia or through their exposures to Australian corporates reliant on Asian markets. These concerns have proven unwarranted, a consequence in part of the successful diversification of Australia's export sales away from Asia. Some Australian banks incurred losses on their Asian lending but these losses were easily absorbed by other profitable parts of their businesses. Asian exposures now account for around 4 per cent of banks' total assets, down from around 6 per cent before the Asian crisis emerged.

The Russian moratorium on foreign debt repayments in August, followed shortly after by the near-collapse of Long-Term Capital Management, precipitated a period of considerable stress in global financial markets, discussed in "Operations in Financial Markets". Financial institutions reassessed credit and market risks and reduced their appetite for accepting risk. The consequence was a sharp rise in credit spreads in the second half of 1998, associated with greater volatility and a loss of liquidity in many financial markets. Initially, this instability triggered fears – especially in the United States – of a "credit crunch" and a resulting pronounced slowdown in world economic activity. These fears, however, were relatively short-lived and while there were some flow-on effects to Australia, they were relatively mild and subsided quickly. Credit spreads rose in September and October and for a brief period new debt issues by Australian companies fell significantly, both in Australia and overseas. However, there was no evidence that Australian financial institutions reduced their willingness to provide credit to sound companies.

At the same time, in the face of global financial turbulence, Australian banks have taken a more cautious approach to their financial market exposures. Many have reviewed and updated their internal risk-management practices. Over the year, banks' exposure to the risk of losses from market movements, as measured by the capital charge for market risk, fell by around 30 per cent. The capital charge for credit risk on off-balance sheet exposures also declined, after increasing strongly for three years.

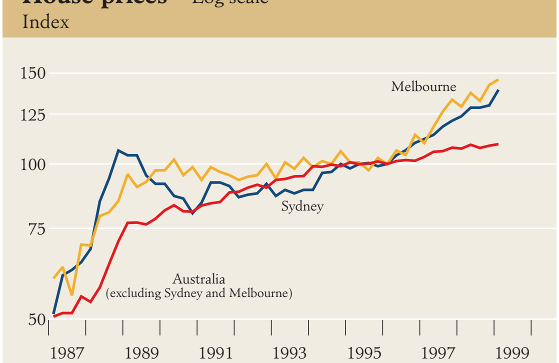
Domestically, the continued rapid expansion of credit has been the most noteworthy development in the Australian financial system over the past year. Credit extended by Australian financial institutions rose by 11.0 per cent, after four years of above 11 per cent annual growth; the major contributor was credit provided by banks, which account for around four-fifths of total credit. By year end, the ratio of credit to GDP was about 100 per cent, well above its peak at the end of the 1980s.

Credit – Per cent of nominal GDP*



* Nominal GDP for June 1999 is an estimate.
** Adjusted for breaks in series

House prices – Log scale*



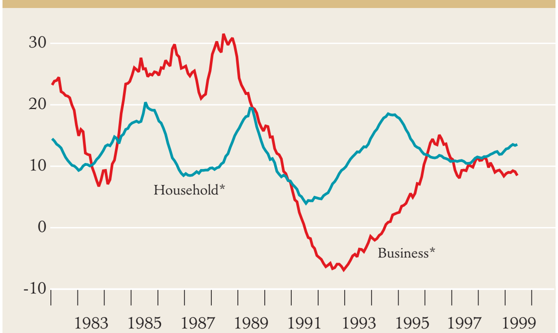
* March 1996 = 100
Source: REIA

The pattern of credit growth, however, is quite different from the experience of the late 1980s. For one thing, growth in credit to households has outstripped growth in credit to business. Over 1998/99, household credit grew by 13.5 per cent, a little above the average rate for the previous seven years. The ratio of household debt to household disposable income has increased from around 55 per cent in 1992 to over 90 per cent, putting the indebtedness of Australian households, on this measure, on a par with a number of other developed economies. Contributing factors include high levels of consumer confidence and the strong performance of the Australian economy, improved access to housing finance as a result of low interest rates and the increasing attractiveness of a range of personal credit products secured by residential property. These same factors, in turn, have been putting upward pressure on residential property prices, most noticeably in Sydney and Melbourne where prices have risen substantially over the past two years. Elsewhere in Australia, house price increases have not been as strong.

Some gearing-up of household balance sheets and rises in real property prices are a natural part of the adjustment to low inflation and improved access to credit. There is always a risk that borrowers and financial institutions will come to expect that ongoing rises in property and other asset prices will become the norm, which could tempt them into excessive levels of debt. If this were to happen, borrowers and financial institutions alike would become more vulnerable to the risk of future slowdowns in economic activity and falls in asset prices. This point is not in sight, in part because low interest rates have helped to keep the repayment burden on the higher debt levels quite manageable. Even so, the Bank will continue to monitor closely movements in household credit and in property and other asset prices.

Business credit has grown at a solid pace, but well below rates experienced during the late 1980s. As a consequence, the ratio of business credit to GDP remains below its 1990 peak, and the combination of low leverage and low interest rates means that debt repayment burdens are well below historical averages. There is also little evidence of overheating in the commercial property market, another point of contrast with the late 1980s. Office construction has grown strongly over the past couple of years, particularly in Sydney, but activity levels and commercial property prices both remain well below their previous peaks.

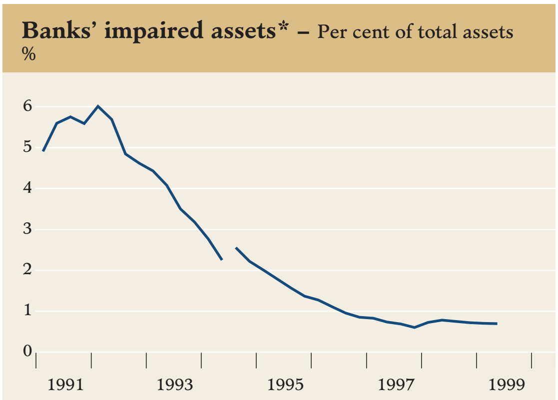
Credit – Year-ended percentage change



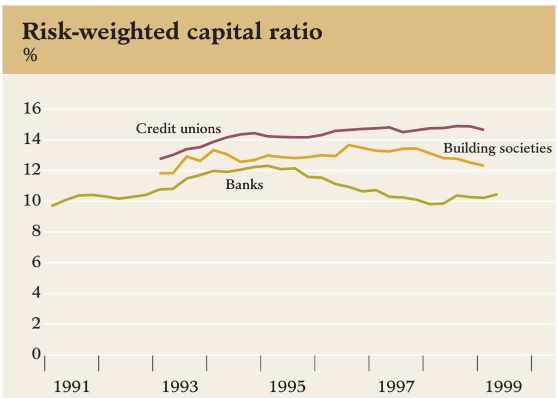
* Adjusted for breaks in series

Importantly, the financial system is much less exposed to commercial property than was the case in the late 1980s. Exposures are also better managed, with institutions assessing lending for commercial property on a portfolio basis rather than simply loan-by-loan. Property trusts have increasingly replaced traditional lenders as a source of finance for property; over the past two years their net new purchases of property have grown substantially and now exceed $5 billion per annum. These trusts borrow from banks but on a relatively small scale. The growing number of property trusts listed on the Australian Stock Exchange has helped to provide a market-based indicator of the current state of the commercial property sector. This should improve transparency, and thus investment decisions, in a market characterised by relatively infrequent trading of actual properties.

Notwithstanding the different undercurrents during 1998/99, the Australian financial system has ended the year with a strong asset base, high levels of profitability and a well-capitalised position. With the credit cycle still in a benign phase, the impaired assets and loan losses of financial institutions remain very low. In the case of banks, the ratio of impaired assets to total assets rose a little in the first half of 1998, partly because of fall-out from the Asian crisis, but some of the increase has subsequently been reversed; the ratio stands around



* Break in series in September 1994



0.7 per cent, just above its minimum point this decade. The favourable loan loss experience, strong growth in non-interest income and cost-cutting initiatives have enabled financial institutions to maintain their profitability in the face of further falls in interest margins.

The capital ratios of banks, building societies and credit unions remain comfortably above minimum required levels. The aggregate risk-weighted capital ratio for banks rose over the year to 10.5 per cent, following three consecutive years of falls. The issue of preference shares by a number of banks was a factor in this increase. The major Australian banks have also been moving to forward-looking provisioning policies which supplement historical loss experience with expectations about future economic conditions; this contributed to a build-up in general provisions for bad and doubtful debts in the second half of 1998.

Payments system developments

The Payments System Board of the Reserve Bank was formally established on 1 July last year. The Board has responsibility for the safety of the Australian payments system and for promoting efficiency and competition within that system, consistent with overall financial stability. The Board oversees the Reserve Bank's new and comprehensive powers in this area which allow the Bank, amongst other things, to determine rules for participation or set standards for safety and efficiency in a particular payment system. These responsibilities and powers are unique amongst central banks and supervisory authorities.

Non-executive members of the new Payments System Board: (left to right) Joe Gersh, Graeme Thompson, Sue McCarthy and John Thom.

The Payments System Board did not draw on these broad powers during 1998/99. Its initial task has been to undertake a "benchmarking" of the Australian payments system, addressing both its safety and its efficiency. That benchmarking has confirmed the general soundness of the domestic payments system, particularly following the successful implementation of the RTGS system, allowing the Board to turn its attention to a major global initiative to reduce foreign exchange settlement risk (the Continuous Linked Settlement Bank), which will include the Australian dollar. At the same time, the benchmarking has identified some areas – such as cheque-clearing times and the usage of direct debits – where there is obvious potential to improve efficiency. Though recent progress has been made in reducing cheque-clearing times, the Board has indicated that it wishes to see all banks work to a three-day cheque-clearing cycle as "best practice" in Australia. The Board's activities will be described in a separate Annual Report to be published in September.