Current Banking Issues

Talk by the Deputy Governor, Mr G.J. Thompson, to the First Pacific Stockbrokers Australasian Banking Conference, Melbourne, 26-27 September 1996.

The Current Banking Scene

At this Conference a year ago I noted that the banking system was in pretty good shape. This description is still apt, as the following indicators illustrate:

- After-tax *profits* during 1995/96 increased to around 16 per cent of shareholders' funds – a healthy enough return, when compared with inflation of 3 per cent and a 10-year bond yield below 8 per cent.
- Banks' average *capital* ratio, on a risk-weighted basis, is just over 11 per cent, which is about one percentage point lower than a year ago but still comfortably above the standard minimum of 8 per cent. In fact, the ratio for Tier 1 capital alone is about 8½ per cent. The average capital ratio for regional banks rose over the year, to about 12½ per cent, with the reduction in the overall ratio due largely to a couple of overseas acquisitions and share buy-backs by major banks.
- Total bank *credit growth* has been 12 to 13 per cent – with the increases for housing, other personal and business loans all close to this average.
- *Asset quality* remains sound – the percentage of impaired assets in total assets was about one per cent in June, compared with 1¾ per cent in the middle of 1995 and a peak of 6 per cent in the early 1990s. Loan write-offs were lower in 1995/96 than in the year before, while loans newly identified as impaired have been steady (at around $0.8 billion) over recent quarters.

Banks have been able to maintain profitability even though their overall *interest margins* declined again in 1995/96. In part, this was made possible by further reductions in costs, with the ratio of operating *expenses* to income falling slightly over the year.

Possibly the most interesting development in the past year was the outbreak of price competition in mainstream home lending.

Competition in Home Lending

Beginning in 1994, the dominance of banks in the profitable housing loan market has been strongly challenged by non-bank mortgage managers, funded mainly by the issue of mortgage-backed securities to wholesale investors. They accounted for about 9 per cent of all new housing loan approvals in the past year, up from one per cent not long ago. (Life offices are also becoming more active in home lending, but remain far less prominent than

in the early 1960s when they had a quarter of the market.)

The success of the mortgage originators has been due partly to the combined effects of deregulation and low inflation – which have tended to raise the average cost of banks' deposit funds relative to the market interest rates at which the originators fund themselves. This narrowing of the banks' funding advantage, together with their higher operating costs, left a large opening for the originators to exploit.

As you know, the banks first tried to meet this competition with special offers aimed only at new customers, including:

- 'honeymoon' loans, with a lower interest rate for the first year;
- 'no frills' loans, at interest rates well below the standard variable rate; and
- fixed-rate loans, at competitive rates.

By mid 1996, however, banks were forced to reduce their standard variable rate, for new *and* existing customers, as borrowers became more willing to 'shop around' and banks' market share continued to erode.

Since then, the spread between banks' standard variable housing rate and short-term money market rates has fallen to around 2 per cent, compared to 4 per cent only a couple of years ago. The latest declines in housing margins have not yet reflected in the data on banks' overall margins, and virtually guarantee that these will fall further in 1996/97.

What are the likely effects on profitability? We estimate that, on an '*other things equal*' basis, the decline so far in housing margins could reduce the major banks' return on equity by about one percentage point. For regionals, which do relatively more home lending, the impact might be about 3 percentage points. The *actual* net impact on profits will, of course, vary from bank to bank, and will depend on what other changes occur in fees, costs and so on. We will no doubt see:

- more strenuous efforts to recover directly the cost of transactions and other services and unwind the cross-subsidisation of these services from interest margins. So far, banks have not made much progress in raising the overall proportion of their income gathered in fees and charges;
- increased resort to alternative methods of distribution, such as mobile lenders, telephone banking and the Internet. Moves in these directions have already been made by many banks; and
- continuing pressure to cut operating expenses, especially through closing and reconfiguring branches. Banks will also, however, have to commit large sums on investment in new technology.

Regional banks will also probably intensify efforts to reduce their reliance on housing by diversifying into commercial and other personal lending. Aggregate statistics indicate that, so far, little progress has been made in this direction although, again, the picture varies from bank to bank. Interestingly, some regionals seem to have been more successful in diversifying their exposures geographically, lifting significantly the proportion of home lending sourced outside their home state.

I note that the more competitive housing market seems to have gone with some weakening in the quality of loan portfolios, but the extent does not give rise to prudential supervision concerns. Banks' housing loans past due by 90 days or more are now almost double their level at the beginning of 1995. However, such loans still represent less than one per cent of total housing portfolios.

An intriguing question is whether housing margins will fall further. In speculating about this, it might be relevant that the margin between banks' standard housing and short-term funding rates in Australia is still higher than comparable spreads in other countries.

Innovations in Finance

Events in the home lending market are an example of specialist entrants competing for a particular line of bank business. An earlier example was the cash management trusts. We

are likely to see more of this as new technology makes possible alternative distribution channels which can displace banks' branch networks as points of contact with customers, and as low inflation continues to reduce the advantage to banks of their low-cost deposits. In addition, the funds management sector will continue to grow in relative importance, as a result of government policies to encourage retirement saving and the community's desire to diversify its financial wealth. This will raise the demand for securities for investment portfolios, creating opportunities for the banks to securitise the more standard loans on their balance sheets, but also making it easier for some financing to by-pass them altogether.

These trends clearly pose significant commercial challenges to the banks. They call for responses along the lines of those we are seeing in the housing market and in the payments system where banks are establishing alliances with software and communications specialists.

The more nimble the banks are in these areas, the more successfully they will maintain their current positions of dominance in most markets. The capacity of Australian banks to respond to innovation and competition is often understated. They have been relatively quick to adopt new technology and their customers are relatively sophisticated users. Either in their own right or through subsidiaries, banks can undertake virtually any form of financial activity – funds management, securitisation, underwriting, life insurance and so on. The main supervisory conditions are that customers understand clearly what sort of product they are purchasing, and that activities outside the bank proper do not put at risk the capital supporting depositors' funds.

The Wallis Inquiry will have to decide what the emergence of new competitors like the mortgage originators means for supervision and regulation. This will require separating the genuine public policy issues from the hyperbole of some established players.

It seems clear enough that the entry, or potential entry, of new players in banking markets should be taken into account in assessing the intensity of *competition* and considering proposals for mergers and acquisitions.

It is much less clear that these innovations have major implications for *prudential supervision*. As we outlined in our submission to the Inquiry, banks are supervised more closely than other financial institutions not only because they remain the biggest group in the system, but because the *bundle* of activities they undertake makes their health particularly important to the robustness of economic activity and, conversely, because serious weaknesses among banks can pose a threat to broader economic and financial stability.

Banks are more vulnerable than other institutions to loss of depositor confidence because their liabilities are relatively short-term and fixed in value, while their assets are mainly long-term and difficult to value. A run on one bank can become contagious. Banks are the main lenders to small and medium commercial borrowers who do not have direct access to capital markets and who have difficulty getting alternative funding quickly if their normal source dries up. Finally, banks have extensive linkages with each other – both through the payments system and financial market trading – so that a problem in one can spread rapidly. (The introduction of real-time gross settlement for high-value electronic payments will substantially reduce, but not eliminate, interbank payment risk.)

This is familiar ground. The important point is that, despite the innovations occurring in financial markets, banks *remain* 'special' in having this bundle of functions and will continue to warrant particular supervisory attention as a result. In countries like the United States, where the banking sector is a much smaller proportion of the financial system than in Australia, special importance is still attached to its supervision.

These issues are explored more thoroughly in the RBA's submission to the Wallis Inquiry and in our recent publication, 'The Future of the Financial System'.

Prudential Supervision Issues

I would like now to comment on two current developments in bank supervision policy.

Tripartite arrangements with external auditors

In consultation with banks and their auditors, we've been seeking to improve the longstanding arrangements under which the auditors give us independent assurances about the effectiveness of banks' management systems for monitoring and controlling risks. For some time, we've felt that the auditors' views on the adequacy of banks' systems gave little useful guidance to potential problems.

Under new arrangements, which come into effect very soon, each bank's chief executive will be required to provide us annually with a declaration, endorsed by his or her board, stating that management has:

> '…identified the key risks facing the bank, has established systems to monitor and manage those risks including, where appropriate, by setting and requiring adherence to a series of prudent limits and by adequate and timely reporting processes; that these risk management systems are operating effectively and are adequate having regard to the risks they are designed to control; and that the description of systems held by the Reserve Bank is accurate and current'.

We expect that these declarations, which are due within three months of the end of each bank's financial year, will help focus the attention of boards on their responsibilities for clearly articulating a bank's appetite for risk and then for ensuring that the appropriate framework of risk management is in place. The first declaration will be provided by those banks whose financial year ends this month.

The second new element is that external auditor reports to the RBA will in future concentrate on the scope and effectiveness of systems in *particular* areas of a bank's operations, rather than offering a general view on a range of systems. The subjects of these targeted reviews will be selected at the annual meeting between each bank, its auditors and the RBA around the end of the bank's financial year, with the relevant report submitted in time for assessment before our next tripartite meeting.

Market risk and capital adequacy

In August, we sent banks copies of a draft Prudential Statement on capital adequacy guidelines in relation to market risk. This is modelled closely on the international guidelines issued by the Basle Committee on Banking Supervision in January this year and extends the existing capital framework to capture the risks associated with banks' trading activities – that is, the risk of losses from movements in interest rates, exchange rates, equity prices and commodity prices.

In calculating capital requirements for market risk, banks will have the choice of two methods:

- the 'standard measurement' approach, or
- their own internal risk management models, subject to these satisfying several qualitative and quantitative criteria.

The decision to allow the use of in-house models to measure risk is a significant departure from past supervisory methods. It recognises the shortcomings of more prescriptive standard approaches in areas which are characterised by ongoing innovation and where some banks already employ sophisticated risk management models tailored to their own operations.

Under the Basle guidelines, national supervisors have discretion in several areas in applying the new arrangements. We have used this in deciding not to accept term subordinated debt with maturities as short as two years as eligible capital – 'Tier 3 capital' – even with lock-in conditions to prevent repayment if this would leave capital ratios below the required minimum. We remain unconvinced that such debt has the features required of capital, and we have doubts about the practicality of the lock-in conditions. Consequently, it is difficult to justify the additional complexity which Tier 3 capital instruments would bring to measuring capital

ratios. Moreover, it is uncertain how attractive these securities will be to investors.

If, in the future, it seemed that Australian banks were being competitively disadvantaged by their lack of access to the additional tier of capital we would be prepared to review our position.

We've asked for final comments on the draft Prudential Statement by the end of this month, and intend to introduce the new framework at the end of 1997. Individual banks may seek earlier implementation.

While these guidelines represent an important and desirable extension of the capital adequacy framework, their impact on Australian banks seems likely to be small.

No bank has indicated a need to raise additional capital as a result of the new guidelines. This is not surprising given the existing excess of capital over current requirements and the small additional amounts of capital likely to be required by most banks to cover their market risks. In fact, because existing credit risk charges will be replaced by lower 'specific' risk charges for interest rate and equity products, it's possible that some banks could actually need less regulatory capital under the new guidelines. (Macquarie Bank, for example, in its 1996 Annual Report suggested that it would have been in this position had the new guidelines been operative.)

We are now into our second round of on-site visits to review banks' systems for managing market risk. These visits, which complement the parallel program looking at management of credit risk, focus on the controls used by banks in their trading activities, including in relation to derivatives.

Our judgment is that the risk measurement methodologies used by the Australian banks with major treasury operations are relatively advanced by international standards – although this does not mean there is no room for improvement. Also, we would like to see more stress testing to assess how management systems would cope with unexpected but possible shocks in market conditions.

Directions in Bank Supervision

The two policy developments I've touched on illustrate the trend for supervisors to put more reliance on banks' own management systems, and to emphasise that the primary responsibility for their sound operation lies with their boards and senior management. This thrust, which is endorsed in submissions to the Wallis Inquiry by several banks, is consistent with trying to avoid the inefficiencies and costs which more prescriptive styles of supervision can entail. It also recognises that for banks engaged in extensive market activities – where exposure positions can change quickly – the quality of internal management systems is a key defence against large losses. This message has been driven home by the recent problems of Barings, Daiwa and Sumitomo. Supervisory monitoring of historical capital positions, on its own, is not enough.

Bank supervisors are also expecting banks to improve the quality of information disclosed publicly. This helps the market professionals to exercise their own disciplines on banks, as a complement to supervision. We have, for instance, been encouraging banks to upgrade information on asset quality and off-balance sheet activities, particularly derivatives, and it has been gratifying to see a marked increase in the volume of useful information published in the past year.

It's been argued in certain quarters that the greater complexity in some areas of banking renders prudential supervision ineffectual, and that it should eventually be replaced by a disclosure regime where depositors and investors have to make their own judgments about the soundness of banks. I think this misses the point that greater complexity and more rapid change in the business of many banks severely limit the extent to which a public disclosure regime could realistically substitute for official supervision, with all its limitations. The public has neither the time

nor the expertise to make continuous informed assessments of banks.

It is also more than a little naive to suggest that disclosure-based regimes can do away with community expectations that the Government will have to take a close interest in resolving any threats to the health of the banking system.

End Piece

I hope that these comments have been a useful scene-setter for the discussions to follow over the next two days, and I wish the rest of the Conference well.