FINANCIAL STABILITY REVIEW

September 2007

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Overview

The past couple of months have seen a marked tightening in conditions in global credit markets. This tightening comes after several years in which credit was generally available on very favourable terms and risk was widely considered to be underpriced. It has been associated with a retreat from risk taking and the emergence of liquidity pressures in inter-bank markets in a number of countries. The effects have been felt in a wide variety of markets, with credit spreads having risen and volatility in currency and equity markets increasing. Overall, market conditions have been characterised by considerable nervousness, and investor confidence – particularly in structured credit products – has been dented.

These adjustments reflect, to a large extent, an increase in the compensation that investors require for holding risk as well as an increase in the perceived riskiness of some mortgage-related investments, rather than a fundamental reassessment of the risks to the global economy. The catalyst for the adjustment was the difficulties in the sub-prime mortgage market in the United States. The effects have, however, been amplified by the resulting uncertainty regarding the value of a wide range of securities, particularly those related to housing loans. Investors have been unsure about both the size of the losses arising from the sub-prime problems, and who will ultimately bear these losses. As a result, many have taken a cautious approach, preferring cash and government securities over assets where liquidity and pricing transparency are poor. A lack of confidence over where spreads will eventually settle has also reduced investor demand. In this environment, financial institutions have placed a premium on liquidity, unsure as to future funding commitments, including future drawdowns of existing commitments.

Viewed in a medium-term context, some adjustment in risk spreads is to be welcomed, increasing the likely durability of the current global expansion. However, the nature of the adjustment process has taken many observers by surprise. Not only have investors required more compensation for a given risk, but many have also been reluctant to commit their funds for other than very short terms. Banks have found themselves at the centre of the current stresses, in part because a significant amount of the financing of recent years that occurred through capital markets has had to be brought back onto banks' balance sheets.

While conditions in global markets remain tight, the past week has seen inter-bank spreads decline appreciably and some easing in funding conditions. This is a welcome development, though it is too early to be confident that there will not be further bouts of market turbulence and strained liquidity conditions in the period ahead. Underlying this improvement is the fact that the credit quality of corporate borrowers in most countries is sound and that the core financial institutions around the world typically have healthy balance sheets. Also, the outlook for the world economy remains positive, notwithstanding prospects for slower growth in the United States. It is, however, both likely and appropriate that credit spreads on a wide variety of assets will settle at higher levels than those seen over recent years, and that credit will not be available on as generous terms as has been the case recently.

The Australian financial system has also been affected by the strains in global credit markets, with inter-bank interest rates for term funding rising, credit spreads increasing, and both the currency and equity markets exhibiting greater volatility. The effects, however, have not been as pronounced as in some other countries, despite Australia having a large securitisation market and some banks relying heavily on capital markets for their funding. This reflects a number of factors, including the very limited exposure of Australian banks to the US sub-prime market and the very small size of the Australian non-conforming loan market (the closest equivalent to the US sub-prime market). In addition, arrears rates on Australian mortgages remain low by international standards. Australian financial institutions have been able to roll over maturing liabilities, albeit at higher interest rates than previously, and some have shifted their funding from offshore to domestic markets.

Overall, the Australian banking system remains highly profitable and is well capitalised. Balance sheets have continued to grow strongly over the past year, bad loan expenses remain low, and banks have benefited from strong growth in income from their funds management operations. Looking forward, the current increase in funding costs is likely to have some impact on the nature of competition in the financial system. Traditional lenders that rely relatively heavily on retail deposits to fund their loans are likely to see their competitive position improve, and this in turn is likely to see more loans funded on the balance sheets of financial institutions, rather than in the capital markets.

More generally, the domestic economic and financial environment remains supportive of financial stability; the Australian economy is continuing to grow at a strong pace, with household and business balance sheets, overall, being in good shape. The share of households experiencing financial difficulties remains low, although it has increased over recent years, largely reflecting the much wider availability of credit over the past decade. Households are benefiting from strong income growth and low unemployment, with household wealth rising solidly recently. While there are some pockets of stress, particularly in western Sydney, most households are reasonably positive about their personal finances. Business balance sheets also remain in good shape overall, with debt-servicing ratios and arrears rates remaining low.

The Global Financial Environment

Over the past few months there has been an abrupt reversal of the favourable credit conditions that had existed in global markets for some years. Spreads have widened on a broad range of debt securities, volatility in financial markets has increased and funding conditions for financial institutions have tightened considerably. These adjustments come after a number of years in which there were widely held concerns that risk was being underpriced, that many financial assets were being valued on the assumption that benign conditions would continue indefinitely, and that many investments had more 'embedded' leverage, and were more risky, than widely appreciated.

Many of the movements in the prices of financial assets over the past month or so can be viewed as part of a global repricing of risk, partly due to increased risk aversion by investors, rather than as a response to a fundamental reassessment of the outlook for the global economy. Investors now require more compensation for accepting a given risk, and also perceive there to be more downside risk in structured credit products, than they did just a short time ago. The premium placed on liquidity has also increased significantly. Notwithstanding this, the core financial institutions in the major economies remain sound.

A distinguishing feature of recent developments has been a sharp increase in uncertainty. In part, this reflects considerable opacity about where, and when, the full scale of credit losses on US sub-prime housing loans will show up. Adding to the uncertainty is the fact that many of the newer structured products are difficult to understand and have never really been tested in an adverse environment. The complexity of these products has also meant that transactional liquidity is often extremely limited, complicating the task of accurately valuing these products and adding to volatility. Financial institutions have also been uncertain regarding their future funding requirements. In this environment, the process of returning to more settled market conditions would be aided considerably by greater transparency by institutions and investment funds regarding the scale of any losses arising from the sub-prime problems and the consequent global repricing of risk.

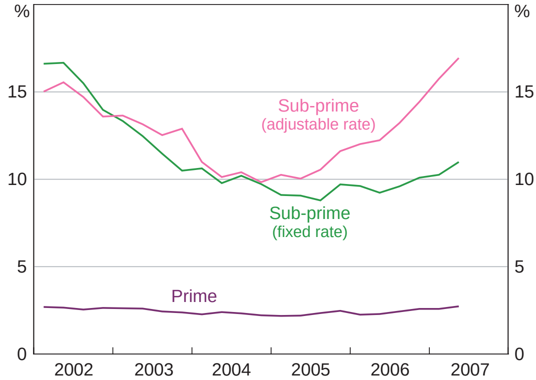
Problems in the US Sub-prime Mortgage Market

The catalyst for the recent adjustments was the worsening problems in the US sub-prime mortgage market. As discussed in the previous *Review*, there has been a marked increase in the delinquency rate on sub-prime mortgages, particularly those with adjustable interest rates, since the middle of 2005. According to data from the Mortgage Bankers Association, the 30-day arrears rate on US sub-prime adjustable-rate mortgages was around 17 per cent in June, up from 10 per cent in mid 2005 (Graph 1). While this rate is only slightly above the previous peak in 2002, the sub-prime market is now much larger, accounting for around one fifth of all mortgage originations in 2006

Graph 1

US Mortgage Delinquency Rates

30+ days past due, per cent of outstandings

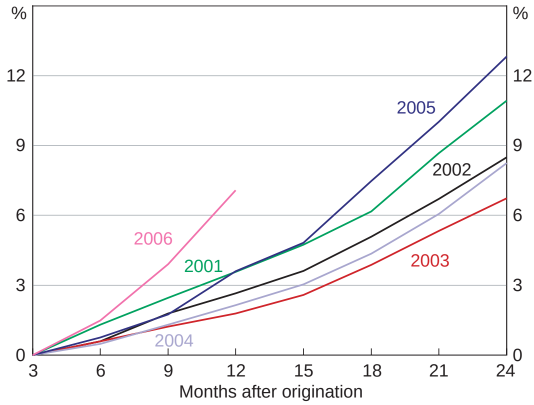


Source: Mortgage Bankers Association

Graph 2

US Sub-prime Mortgage Delinquency Rates

60+ days past due, per cent of outstandings



Source: BIS

and about 15 per cent of the stock of outstanding loans, compared with around 8 per cent of outstandings in 2002. A further deterioration in the arrears rate is widely expected over coming months, with loans made in 2006 experiencing a significantly worse repayment record than loans made in earlier years (Graph 2). Furthermore, the interest rate on many of these loans will increase as the introductory discounts expire; estimates suggest that loans with a total value of about US$450 billion – equivalent to around 30 per cent of the stock of outstanding sub-prime loans – will have their interest rates reset in 2007/08.

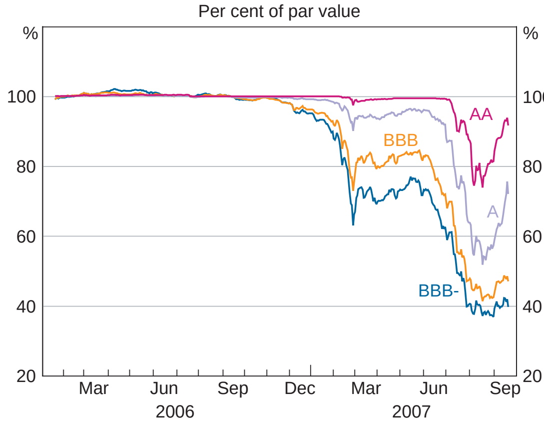
The rise in sub-prime delinquencies reflects a number of factors, including lax underwriting standards – particularly for loans originated in 2005 and 2006 – and falling house prices. In recent years, there was very strong competition in the sub-prime mortgage market, supported by low funding costs and strong demand by investors for residential mortgage-backed securities (RMBS); of the estimated US$2 trillion of RMBS issued in 2006, around a quarter were backed by sub-prime mortgages. One result of this competition was a significant weakening of credit standards, with many lenders being prepared to lend to borrowers with very high risk profiles. As mortgage interest rates rose over recent years from their previous very low levels, and house prices fell or showed limited appreciation, many of these borrowers have had difficulty meeting their debt obligations.

Since the problems in the sub-prime market first appeared, a large number of mortgage originators in the United States have closed. While all originators of sub-prime loans have experienced much tighter funding conditions, some have also been required by contractual obligations to buy back underperforming loans. The total potential losses on sub-prime mortgages remain difficult to determine, although some estimates exceed US$100 billion (compared with total outstanding mortgage debt in the United States of around US$10 trillion).

Reflecting the uncertainties around the credit quality of sub-prime debt, there have been sharp falls in the prices of indices of credit default swaps on sub-prime RMBS. For tranches of sub-prime RMBS rated BBB-, the index has fallen to around 40 per cent of par value since the beginning of the year (Graph 3). For AA-rated tranches, the index fell significantly in July this year, though much of this fall has since been reversed.

Graph 3

Sub-prime RMBS Index Prices*



* Based on credit default swaps that reference tranches of sub-prime mortgage-backed securities. ABX.HE 06-1 index family to 19 July 2006 and ABX.HE 06-2 thereafter.

Sources: JPMorgan; RBA

Contagion to Other Markets

When the problems in the sub-prime market first emerged earlier this year the spillover to other markets was relatively limited. While the spreads on RMBS widened noticeably and the prices of collateralised debt obligations (CDOs) with exposure to these securities fell significantly, the effects on credit and other financial markets were relatively limited.

Broader contagion then became apparent in mid to late June, around the time that Bear Stearns, a large US investment bank, announced significant losses in two of its hedge funds that had invested in sub-prime related debt. A number of other funds, including some in Australia, also announced losses around the same time, freezing redemptions. Some of these funds were using securities backed by sub-prime mortgages as collateral for further borrowing, which meant that as the value of the securities fell, the funds were required to provide additional collateral or repay the loans. This put further downward pressure on the prices of these securities and heightened concerns about the potential damage that could result from a widespread firesale of these securities. These concerns were compounded as investors in a number of hedge funds requested redemptions, placing further strains on liquidity and security prices. Also, in mid July, the credit rating agencies downgraded a large number of mainly speculative-grade sub-prime RMBS and related CDOs, after assumptions about delinquency levels in their modelling were revised.

Then in early August, BNP Paribas, a large French bank, announced that it was suspending withdrawals from its funds that had invested in US sub-prime related debt, on the grounds that it was increasingly difficult to value the underlying exposures. This announcement, which came on the back of growing concerns about the exposures to sub-prime related debt of some state-owned German banks through their so-called credit arbitrage funds, unsettled investors. In particular, it reinforced concerns over the size of the eventual losses on sub-prime mortgages and which institutions would bear those losses. In turn, this led to a sharp tightening of funding conditions for banks around the globe. It also reinforced investors' reluctance to purchase mortgage-related securities, particularly given the uncertainty regarding the future performance of the underlying loans and where credit spreads will settle once the current turbulence recedes.

Funding conditions have been most difficult in the asset-backed commercial paper (ABCP) market, which provides securitised short-term funding for vehicles holding a variety of financial assets (see Box A at the end of *The Australian Financial System* chapter). These vehicles, or 'conduits', allow financial institutions and other lenders to finance loans and other assets off their balance sheets, offering advantages in terms of both regulatory capital and funding costs. These vehicles are typically sponsored by major banks which provide back-up lines of credit and, in some cases, credit enhancement. Over recent years, they have found strong demand for their paper and, as a result, the amount of ABCP issued in the United States had almost doubled over the past couple of years, to about US$1.2 trillion, representing about one half of all US commercial paper on issue and about one quarter of the size of the US Treasuries market.

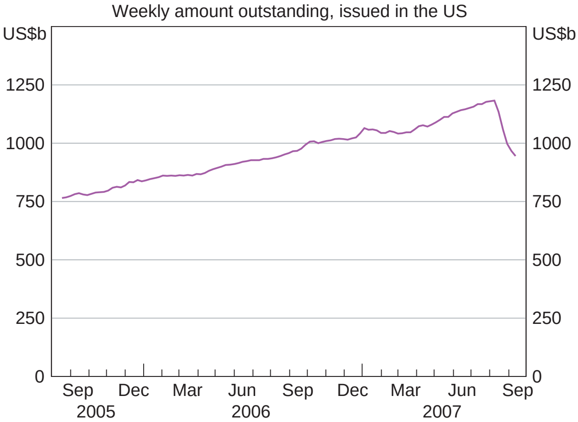
The problems in the sub-prime mortgage market originally saw investors become very reluctant to roll over any commercial paper that was backed by sub-prime mortgages, but this reluctance then spread to a much wider variety of commercial paper, particularly in Europe, where market participants described the market as essentially closed in mid to late August. This experience has reconfirmed that credit markets can have difficulty clearing by adjusting prices in times of increased uncertainty. The uncertainty, and in particular, the difficulty of determining the health of those seeking funds, means that investors may view an institution that is prepared to pay a high interest rate with suspicion. As a result, credit becomes rationed by quantity rather than price.

While conditions have also been very tight in the US ABCP market, borrowers with strong reputations have still been able to place paper, albeit at much shorter maturities and at significantly higher spreads than was the case just a few months earlier. Reflecting these difficult conditions, the value of ABCP outstanding in the United States has fallen by around 20 per cent since the start of August (Graph 4).

Graph 4

Asset-backed Commercial Paper

Weekly amount outstanding, issued in the US



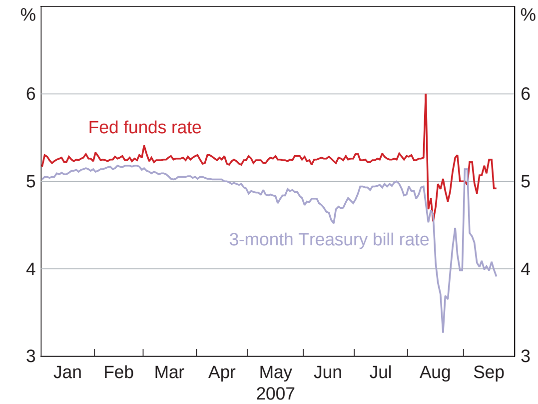
Source: US Federal Reserve

With ABCP vehicles having difficulty rolling over paper, many of these vehicles have had to rely on the back-up lines of credit provided by banks. In addition to having to extend funding to conduits, banks have faced uncertainty over the extent to which other lines of credit will be called upon in the months ahead. In response, banks have taken a cautious approach to their liquidity.

Reflecting this, in early August, overnight interest rates in a number of countries moved noticeably above the level targeted by central banks. For example, on 9 August in the United States, the actual Fed funds rate rose about ¾ of a percentage point above the targeted rate (Graph 5). In Europe, the equivalent rate rose about 60 basis points above its target on the same day. Recognising that these developments had the potential to develop into a more damaging 'credit crunch' if they persisted, most central banks responded by injecting substantial cash balances into their banking systems in order to ease the strains on liquidity in the inter-bank market. Some also extended the range of collateral they accept, and the US Federal Reserve cut the penalty rate on loans from its discount window from 100 basis points to 50 basis points, and extended the maximum term of such loans to 30 days. More recently, the Federal Reserve lowered the target for the Fed funds rate by 50 basis points, citing the adverse effects on the broader economy that might arise from the disruptions in financial markets.

Graph 5

US Money Market Interest Rates

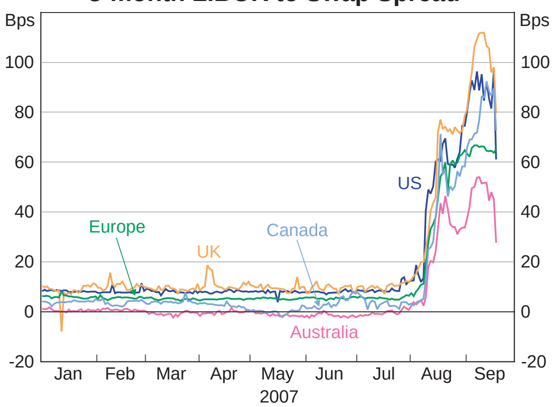


Sources: Bloomberg; US Federal Reserve

While the actions of central banks have proved successful in alleviating the upward pressure on overnight interest rates, the pressures have remained in inter-bank markets for slightly longer maturities. Spreads between three-month interest rates in the London inter-bank market and overnight indexed swap rates – which reflect the expected cost over the equivalent period of rolling inter-bank loans one day at a time – rose sharply in August (Graph 6). While these spreads have declined over the past week or so, they remain much higher than in recent years. These higher spreads have significantly increased the cost of funding for many banks around the world. They not only reflect the global repricing of credit risk, but also the increased premium that investors (including banks) require for holding assets other than those with very short terms, given the ongoing uncertainty about future funding demands.

Graph 6

3-month LIBOR to Swap Spread*



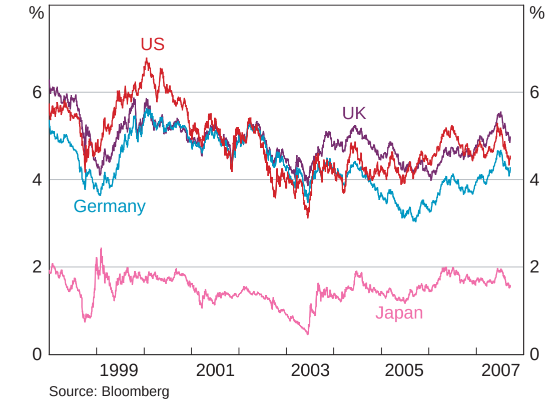
* Spread is to: OIS in Australia, Canada and US; EONIA in Europe; and SONIA in UK.

Sources: Bloomberg; Reuters; Tullett Prebon (Australia) Pty Ltd

The combination of strong risk aversion and desire for liquid assets that characterised markets in August saw a sharp increase in the demand for short-term government securities,

Graph 7

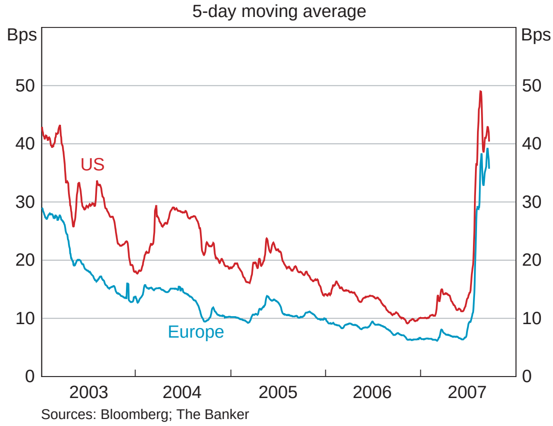
10-year Government Bond Yields



Graph 8

Banks' 5-year Senior CDS Premia

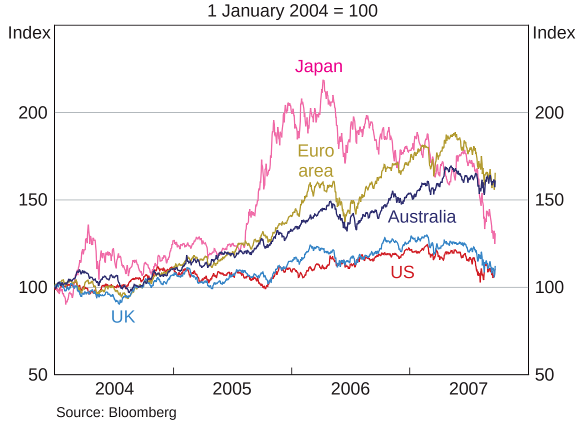
5-day moving average



Graph 9

Share Price Indices – Banks

1 January 2004 = 100



particularly in the United States. Reflecting this, the yield on three-month US Treasury bills fell by about 130 basis points around mid August, to 3.3 per cent, although it has subsequently reversed some of this decline (Graph 5). Longer-term government bond yields in most major markets also fell in August and September, reversing most, if not all, of the increases seen earlier in the year, though they remain above the levels of a few years ago (Graph 7).

The pressures in the banking system were also evident in credit default swap premia on bank debt, which rose sharply in the United States and Europe in early August and have remained elevated in the period since (Graph 8). Similarly, share prices of financial institutions in many countries have fallen relative to the broader equity markets over the past few months, partly reflecting concerns about sub-prime exposures and the impact of higher funding costs (Graph 9). The share prices of investment banks and financial institutions that rely more heavily on wholesale markets for their funding have been particularly affected.

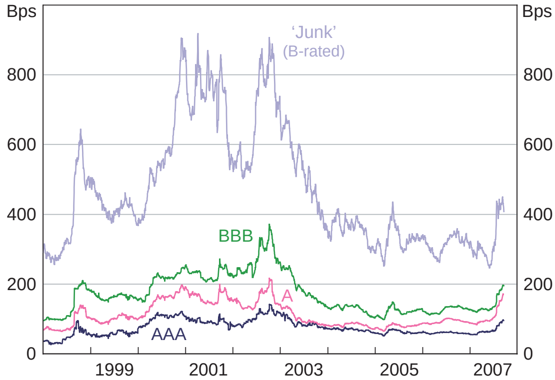
Though the recent widening of credit spreads has been most notable on bank and mortgage-related paper, the increase in risk aversion has also translated into higher credit risk premia on a wide range of other debt securities. In the United States, corporate bond spreads have widened across all credit grades and are now around their highest levels in several years (Graph 10). They are, however, still below the peaks reached in 2002, and the level of corporate bond yields has actually fallen given the lower yields on government securities. Spreads on emerging market sovereign bonds have also widened over the past two months, although to a lesser extent than those on lower-rated corporate bonds in the United States.

A notable aspect of the reduced investor appetite for corporate debt has been the cancellation or postponement of a number of leveraged buyout (LBO) debt issues. In mid July, banks were forced to postpone debt sales for two of the biggest LBOs in the market – US$12 billion of loans for Chrysler and US$10 billion of senior loans for the buyout of Alliance Boots, the UK retailer. In a number of cases, the funding for LBOs has had to remain on the balance sheets of the banks providing the bridging finance. Estimates of the value of loans for LBOs that remain unsold in the United States range from US$230 billion to around US$350 billion. Where LBO deals are proceeding, banks and other debt investors are beginning to impose stricter terms and conditions on the debt packages. Lenders are, for example, less willing to provide 'covenant-lite' loans than in the past.

Graph 10

US Corporate Bond Spreads

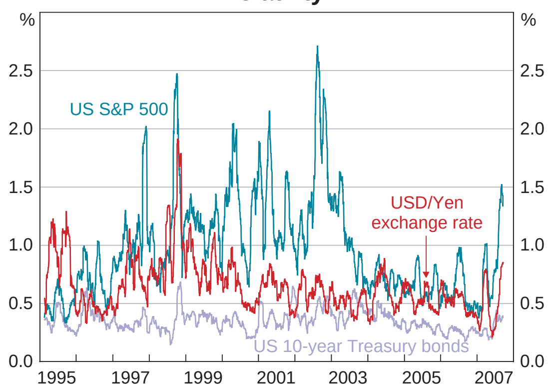
Relative to 7 to 10-year US government bonds



Source: Bloomberg

Graph 11

Volatility*



* 30-day standard deviations of daily percentage changes
Source: Bloomberg

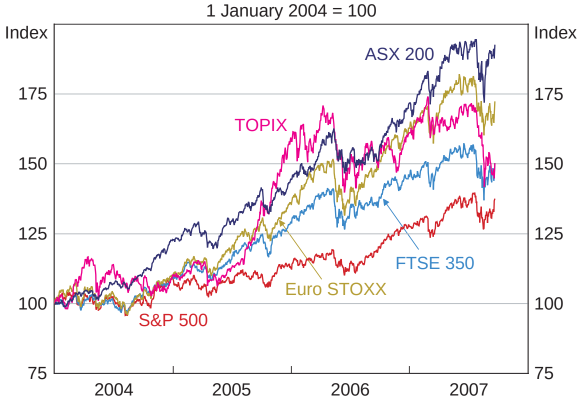
In addition to debt markets, a number of other markets have exhibited increased volatility (Graph 11). Stock markets across the globe fell in August, reversing much of the rise in the first half of the year, though many of them have since recovered significantly (Graph 12). In foreign exchange markets, higher-yielding currencies, including the Australian dollar, depreciated sharply in August as investors unwound carry trades, while the Japanese yen appreciated strongly. Many of the affected currencies have, however, since reversed a large part of these movements.

Notwithstanding the recent strains in bank funding and financial markets, the core financial institutions in major economies remain in good shape. For the most part, banks are well capitalised, have relatively low levels of problem loans, and their returns on equity have been high for a number of years (Graph 13). Nevertheless, in Germany – where bank profitability

Graph 12

International Equities

1 January 2004 = 100

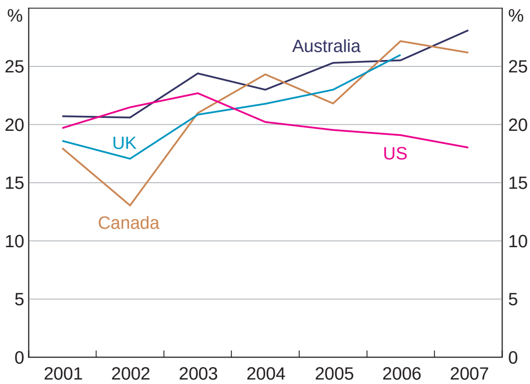


Source: Bloomberg

Graph 13

Banks' Profits before Tax

Return on shareholders' funds

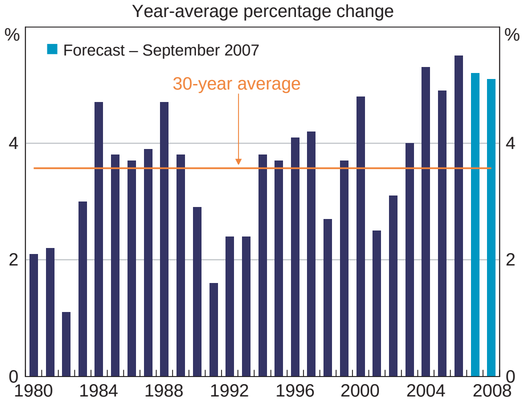


Sources: APRA; banks' annual reports; BIS; FDIC; OSFI

Graph 14

World GDP

Year-average percentage change



Sources: Consensus Economics; IMF; RBA

has tended to be relatively low – a number of smaller banks have had quite large exposures to sub-prime loans via their conduits, and rescue packages have been put together for a couple of troubled institutions. More recently, the Bank of England provided emergency liquidity assistance to a British bank that was experiencing difficulties related to its relatively heavy reliance on wholesale funding markets.

The strong overall performance of financial institutions in recent years reflects the favourable global macroeconomic performance which, in turn, provides some grounds for optimism that the effects of the recent financial market stresses will be contained. The world economy has expanded at an above-average pace over the past four years, with Consensus forecasts as at early September pointing towards continued above-trend growth of a little over 5 per cent in both 2007 and 2008, broadly the same as the forecasts made a month earlier (Graph 14). World growth is also expected to be more broadly based, with growth forecasts for the euro area and China revised up since earlier in the year, offsetting a slightly weaker forecast for the United States.

Issues

As noted above, these developments follow a long period during which risk was widely considered to be underpriced, with this underpricing discussed extensively in previous *Reviews*. As such, the effects of the current repricing are reverberating through a global financial system in which, for a number of years, investors were prepared to purchase assets at high prices, and often with considerable leverage. These recent adjustments have refocused attention on a number of long-standing issues.

The first of these is the importance of liquidity for the smooth operation of financial markets. Over recent years, many commentators have taken comfort from the idea that the stability of the global financial system had been enhanced by the wide dispersion of credit risk as the result of the growth of securitisation and other credit risk transfer markets. Recent events have, however, highlighted the fact that a sudden tightening in liquidity can amplify financial disturbances, even when credit risk is widely dispersed. In effect, the very markets that have allowed this dispersion of credit risk to take place have increased funding or liquidity risk, and made that risk more concentrated. Contrary to some commentators' expectations, the growth of financial markets has further increased the importance of banks for the smooth functioning of the financial system, since it is banks that provide funding liquidity to markets.

A second issue is the extent to which credit risk transfer markets have allowed the banking system to truly shed credit risk. A number of banks have provided securitisation vehicles with large back-up lines of credit, which means that when paper cannot be sold, the underlying credit risk is taken back on to the balance sheets of banks. In addition, some banks that had developed sub-prime backed securities also provided financing to investment funds to purchase those securities, which the banks then held as collateral. Although repurchase agreements are often overcollateralised, the fall in the value of the securities produced a gap between the value of the collateral and the debt owed by the funds to the banks. Without sufficient collateral, the risk transfer from banks is therefore not complete, and the banks have simply replaced their existing exposures to borrowers with counterparty risk to investment funds. Similarly, some banks have operated investment funds that invested in the credit risk transfer markets and have decided to protect investors in these funds from the full losses – even though there was no legal liability to do so – given concerns that investor losses could damage the bank's reputation. While in some circumstances there may be a strong business case to act in this way, the extension of such support means that banks remain exposed to credit risks even when those risks are not held on the balance sheet.

A third issue is the difficulties posed by the growth of trading in instruments that are difficult for investors to understand and where price transparency is poor. The risk characteristics and pricing dynamics of many new financial instruments are highly complex and not fully understood by all investors. In the benign environment of recent years, this did not seem to cause particular concerns, with investors relying on the assessments of the credit rating agencies and the advice of reputable institutions marketing these instruments. However, in the current environment, this complexity and lack of pricing transparency has served to greatly increase uncertainty, amplifying the effects of the initial problems in the sub-prime loan market.

A fourth issue is that the 'originate and distribute' model may have served to increase risk in the financial system. If the institution originating a loan does not ultimately bear the credit risk associated with the loan, its incentives to assess and monitor the credit worthiness of the end borrower may be weakened. In addition, the ability to sell credit risk to other investors may have allowed lenders to make more loans than might otherwise have been the case. As a result, some commentators have questioned whether some aspects of the securitisation model need revisiting.

Each of these issues is likely to be the subject of considerable discussion both by the regulatory community and market participants in the period ahead.

The Australian Financial System

Financial institutions in Australia continue to report high levels of profitability and strong capital positions. In the banking sector, non-performing loans remain at low levels and balance sheets have expanded strongly over the past year, particularly as a result of a pick-up in business credit growth. Profitability also continues to be supported both by restraint in costs and solid growth in income from funds management activities. Reflecting these positive developments and the ongoing strength of the Australian economy, the average credit rating of both banks and insurance companies has increased over the past couple of years.

Notwithstanding these favourable outcomes, the strained conditions in the global financial system, particularly since early August, have also been evident in Australian financial markets. Given the generally healthy state of financial institutions in Australia, and the balance sheets of both businesses and households, these strains have been largely the result of the global repricing of risk, rather than concerns about the credit quality of Australian institutions or mortgage-backed securities.

As has been the case internationally, the funding costs for banks (particularly at shorter maturities) increased appreciably in August and early September, conditions in the market for asset-backed commercial paper became markedly tighter, and financial institutions have been keen to preserve high levels of liquidity. More generally, credit spreads have widened for all borrowers and volatility increased notably in a range of markets. Banks' share prices also fell, although less so than in a number of other countries, reflecting the relatively high credit quality of the Australian banks and their limited direct exposure to the sub-prime problems in the United States.

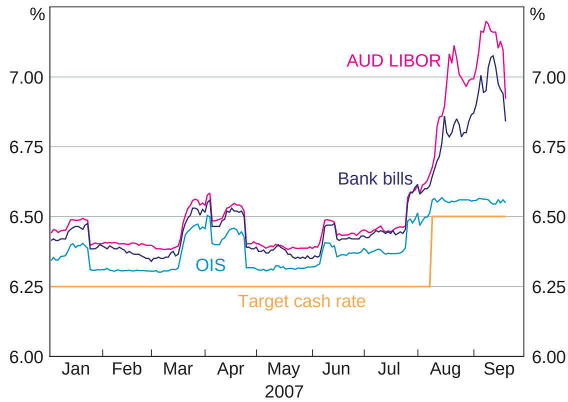
This chapter of the *Review* first discusses recent developments in funding conditions in Australia and the increased volatility in financial markets and then discusses broader balance-sheet developments for banks and insurance companies.

Funding Conditions and Credit Markets

In line with the tightening of conditions in global credit and money markets, short-term funding costs for banks in Australia have risen substantially since early August, as have yields on asset-backed commercial paper. In the first half of August, banks reported a significant rise in the cost of raising short-term funds offshore, with the three-month Australian-dollar LIBOR rate – the benchmark rate for their offshore funding – rising by more than 50 basis points, to a peak of 7.2 per cent. Yields also rose significantly in domestic markets, with yields on three-month bank bills rising above 7 per cent in early September (Graph 15). This rise meant that the spread between the yield on three-month bank bills and the overnight index swap rate for the same maturity reached around 50 basis points. While this spread is historically high, it has remained lower than equivalent spreads in major overseas markets. Over the past week, yields on bank bills have fallen as more settled conditions have returned to global money markets, with three-month bank bill yields currently standing at 6.84 per cent.

Graph 15

Australian Short-term Interest Rates*



* Three months, with the exception of the cash rate which is overnight
Sources: Bloomberg; RBA; Tullett Prebon (Australia) Pty Ltd

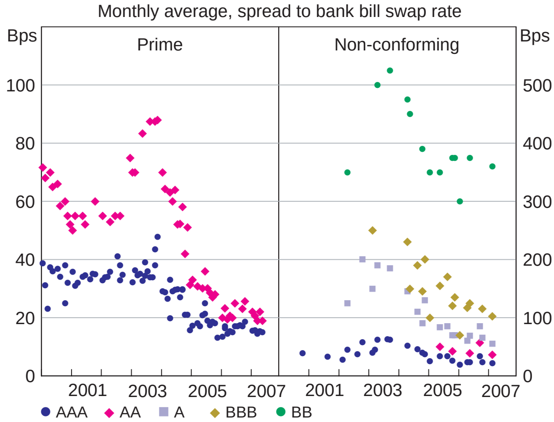
As has been the case in international markets, conditions have been particularly difficult in the asset-backed commercial paper (ABCP) and residential mortgage-backed securities (RMBS) markets. As at end June 2007, there was around $70 billion of rated ABCP issued by Australian entities outstanding (with around one half of this issued onshore). Around half of this paper is directly backed by prime housing loans. Up until quite recently, it was possible to issue ABCP in Australia at a margin of 2 to 5 basis points over the bank bill rate. In contrast, recent issues have been at 30 to 40 basis points over the bank bill rate which, as noted above, has itself risen significantly. Even at these higher rates, a number of issuers have had difficulties rolling over maturing paper and have had to rely on the lines of credit provided by banks to repay the maturing debts. Where paper has been able to be issued, it has typically been for a shorter maturity than was the case up until recently. (Box A provides more information on the Australian ABCP market.)

The difficulties in the ABCP market have been compounded by a sharp decline in investor appetite for RMBS, even those of the highest credit quality. Over recent years there has been strong demand for these securities, both domestically and internationally. This has been reflected in a decline in the spread between the yield on the AAA-rated tranches of RMBS and the bank bill swap rate from around 35 basis points in 2003 to around 15 basis points in mid 2007, and a sharper decline still in the spreads on the lower-rated tranches (Graph 16). In contrast to the consistently strong volume of issuance in recent years, there have been no issues of RMBS since mid July. The increase in risk aversion, and the existence of considerable uncertainty about where the spreads on these securities will eventually settle, has meant that traditional investors in RMBS have preferred to wait until more settled conditions return.

Graph 16

Spreads on Domestically Issued RMBS

Monthly average, spread to bank bill swap rate



Source: RBA

The use of the RMBS and ABCP markets varies significantly across the many mortgage lenders in Australia. Non-bank lenders finance almost all their loans through these markets, with those that have relied heavily on rolling over ABCP, rather than issuing long-dated RMBS, experiencing the more severe liquidity pressures. In contrast, the largest banks make relatively little use of securitisation markets, with the securitised loans of these banks accounting for just 7 per cent of their housing loans outstanding (although they do provide back-up lines of credit to the issuers of ABCP) (Graph 17). Among the other banks operating in Australia, the reliance on these markets varies considerably, although a number of these banks finance more than half their loans through securitisation.

Graph 17

Banks' Securitised Housing Loans*

Per cent of total housing loans outstanding, July

* Includes some non-housing securitised loans
Source: APRA

Given the much tighter conditions in credit markets, both the Australian Prudential Regulation Authority (APRA) and the Reserve Bank recently stepped up their monitoring of liquidity and funding of both institutions and markets. It is clear that the tighter conditions in the ABCP and RMBS markets contributed to a significant tightening in funding conditions for all financial institutions, but particularly for those that rely heavily on these markets, or provide significant back-up lines of credit to issuers of ABCP. While the four largest banks are estimated to have in place lines of credit to rated ABCP issuers of $24 billion, this is equivalent to only 2.2 per cent of their risk-weighted assets.

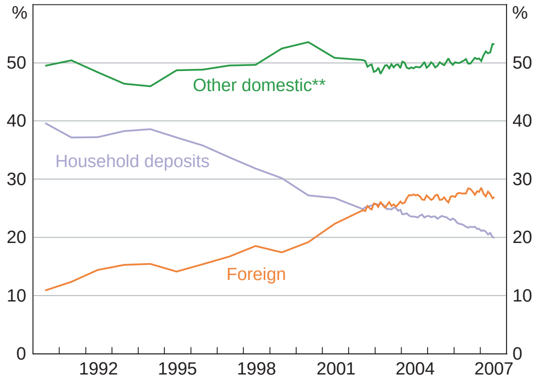
Some loans financed via conduits have been brought back onto banks' balance sheets and more may be brought back in the period ahead. However, unlike banks in some other countries, the difficulties have not been compounded by large exposures to private equity and leveraged buyout deals; a number of overseas banks have had to retain sizeable business loans on their balance sheets owing to the problems some private equity funds have had in raising debt in capital markets.

The large Australian banks continue to be able to issue securities in overseas markets, although at higher spreads than was the case a few months ago. Offshore markets have become increasingly important to these banks over the past decade, with foreign liabilities currently accounting for around 27 per cent of all banks' total liabilities, compared with about 15 per cent in the mid 1990s (Graph 18). The available data indicate that around one third of outstanding offshore debt securities were issued with an initial term to maturity of less than one year, with this share having risen since 2005 (Graph 19). As noted in previous *Reviews*, the foreign exchange risk associated with foreign borrowings is typically fully hedged, so that movements in the exchange rate do not affect the cost of funding. Nonetheless, the higher spreads in these offshore markets, if sustained, will have a noticeable effect on the cost of funding for these banks. This

Graph 18

Banks' Liabilities*

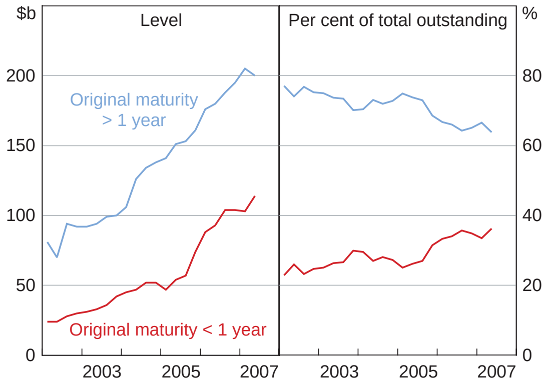
Per cent of total liabilities



* All banks (domestic operations, on-balance sheet). Annual data up to June 2002 and monthly data from July 2002.
** Mainly debt securities and business deposits.
Sources: ABS; APRA

Graph 19

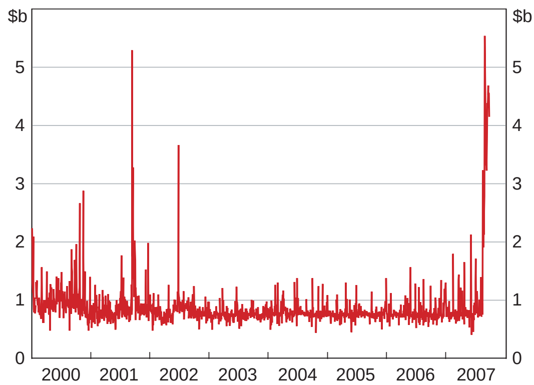
Banks' Offshore Non-intermediated Debt



Source: APRA

Graph 20

Exchange Settlement Balances



Source: RBA

is notwithstanding the fact that some banks have benefited from increased deposit inflows, as some investors liquidated other investments.

Like many other central banks, the Reserve Bank responded to the sharp increase in the demand for liquidity around mid August by increasing the aggregate supply of exchange settlement balances. After the Bank significantly increased the scale of its operations in domestic markets, these balances peaked at around $5½ billion in mid August, and have averaged $4 billion since then, compared with average balances of $750 million over recent years (Graph 20). These operations have meant that the cash rate has remained very close to its target of 6.50 per cent through this period. This is in contrast to the experience of some other countries where the relevant interest rates have moved considerably away from the level targeted by the central bank.

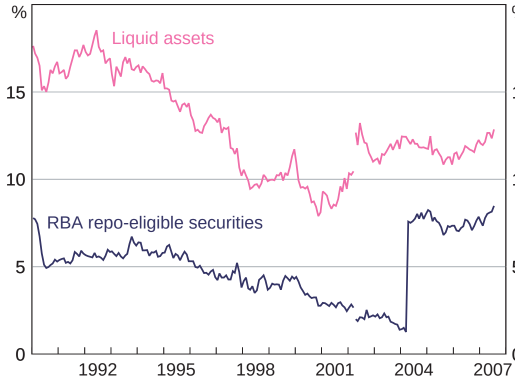
As noted above, while these operations have kept the cash rate – which is the rate for overnight unsecured borrowing – very close to the target, inter-bank lending rates for longer maturities have increased significantly. In part, this reflects the concerns that financial institutions have regarding their future liquidity needs and thus their desire to 'lock in' term funding so as to avoid the relatively risky strategy of funding a significant share of their balance sheet by rolling overnight inter-bank funds. While borrowers have sought slightly longer-term funding, lenders have been reluctant to lend for these longer terms.

In an environment where the future calls on bank-provided lines of credit are uncertain, institutions have a preference for maintaining high levels of liquidity. Over recent years, banks' holdings of liquid assets have averaged around 13 per cent of total assets, with a little over half of these assets being eligible for repurchase transactions (repos) with the Reserve Bank as part of its market operations (Graph 21). These repo-eligible assets have included Commonwealth Government securities, securities issued by State and Territory borrowing authorities, securities issued by certain supra-national and foreign government agencies and bills and certificates of deposit (CDs) issued by some Australian banks. As conditions tightened in mid August, a number of banks issued bank bills to one another to generate additional repo-eligible assets, and the Reserve Bank's holdings of bank bills under repurchase agreements increased significantly. This use of the bank bill market to generate liquid assets has added to the upward pressure on bank bill rates, particularly given the credit limits that banks impose on one another.

Graph 21

Banks' Eligible Securities and Liquid Assets*

Domestic books, per cent of on-balance sheet assets



* Series break in March 2002 due to change in reporting requirements

Source: APRA

On September 6, the Reserve Bank announced that the list of securities eligible for repurchase transactions would be widened. In future, eligible securities include all bills and CDs issued domestically by any ADI which holds an exchange settlement account, certain Australian dollar bonds issued by ADIs, and top-rated RMBS and ABCP backed by prime, domestic 'full doc' residential mortgages.

The increase in market interest rates over recent months has meant that all lenders have experienced an increase in their funding costs. The increases in costs are particularly significant for those lenders that are heavily reliant on the securitisation markets for funding. A number of these lenders have already announced increases in their lending rates, most notably for low-doc and non-conforming loans. To date, however, no lender has increased its indicator rate on prime full-doc loans, although some lenders have reduced the size of discounts that they offer new borrowers, and have tightened lending criteria (for further details see below).

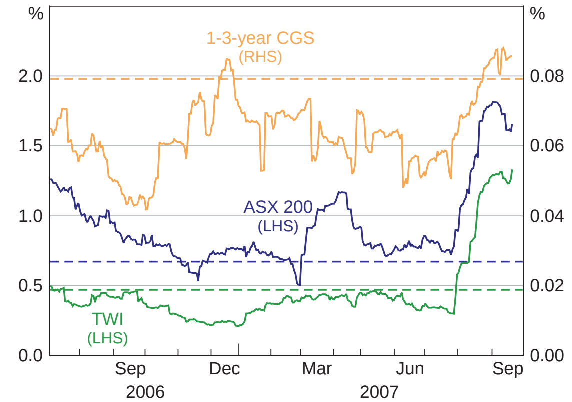
Other Financial Markets

The difficulties in credit markets and the associated increase in risk aversion led to a significant increase in volatility in a number of financial markets in mid August (Graph 22). The Australian dollar depreciated sharply in the first half of August, as the general rise in global risk aversion triggered an unwinding of carry trades. The depreciation was especially large against the Japanese yen, with the AUD/JPY exchange rate falling by around 11 per cent in mid August. Since that time, the Australian dollar has tended to appreciate; on a trade-weighted basis it is around 8 per

Graph 22

Volatility in Financial Markets

30-day standard deviations*



* Dashed lines indicate 5-year average
Sources: Bloomberg; RBA

Graph 23

Australia and US Share Prices

2 January 2007 = 100

Source: Bloomberg

cent higher than in mid August, and around 1 per cent lower than its level in late July.

Bond markets have also been more volatile than in the recent past, although unlike in the United States there has not been a flight to short-term government bonds; despite this volatility, there has been little net change in the level of bond yields since mid August. The stock market was also characterised by considerable volatility in August, with daily volatility reaching its highest level since December 1997. Like the Australian dollar, the equity market was weakest in mid August, with the decline from the peak in late July equal to around 12 per cent. Since mid August, the market has tended to strengthen, and is currently only just below its July peak.

The share prices of the Australian commercial banks also declined in mid August, although they have subsequently increased and are around 5 per cent higher than at the beginning of the year; in contrast, share prices of similar banks in the United States are about 5 per cent lower over this period (Graph 23). The Australian commercial banks have slightly underperformed the broader market since mid July. Equity market analysts expect financial institutions' earnings growth to remain strong, with earnings per share forecast to grow by around 10 per cent over the current financial year, and 8 per cent in 2008/09. The share prices of Australian institutions which focus on investment banking have faired less well; they are generally a little lower than they were at the beginning of the year, but have outperformed their US counterparts.

Credit default swap premia for Australian commercial banks have also risen quite sharply, although this is likely to reflect primarily a change in the required compensation for risk, rather than a fundamental re-evaluation of the probability of one of these banks defaulting. The increase in these premia has again been less than for equivalent banks in many other countries (Graph 24).

Deposit-taking Institutions

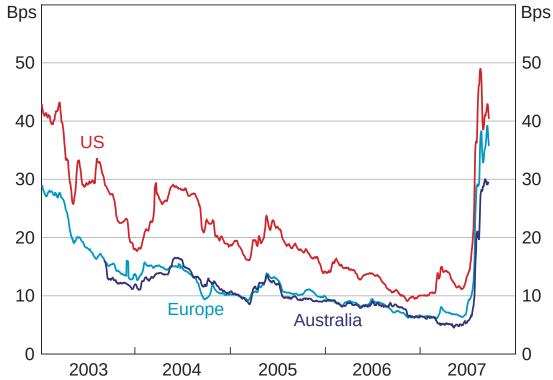
Profitability

The recent strains in financial markets have occurred against a backdrop of an Australian banking system that is highly profitable. The five largest banks recorded aggregate pre-tax profits of around $13.6 billion in the latest half year, an increase of 13.5 per cent compared with the same period a year earlier (Table 1). The annualised pre-tax return on equity was 28.1 per cent, slightly higher than the 2006 full-year result and around the average of the past decade or so (after adjusting for a change in accounting standards) (Graph 25).

Graph 24

Banks' 5-year Senior CDS Premia

5-day moving average



Sources: Bloomberg; The Banker

The banking sector's strong performance continues to be underpinned by robust balance sheet expansion, with total assets (excluding intra-group activities) on banks' domestic books increasing by around 18 per cent over the year to July 2007. This mainly reflects the ongoing strength of domestic lending, particularly to the business sector, with the assets of foreign-owned

Table 1: Banks' Half-Year Profit Results[(a)]

Five largest banks, consolidated

	2006 $b	2007 $b	Growth Per cent	Per cent of average assets[(b)]
Income				
Net interest income	14.6	16.1	10.0	1.9
Net income from wealth management	3.3	4.0	20.7	0.5
Other non-interest income	6.9	7.0	0.8	0.8
Expenses				
Operating expenses	11.9	12.2	2.9	1.5
Bad and doubtful debts	1.0	1.2	25.2	0.1
Profit[(c)]				
Net profit before tax	12.0	13.6	13.5	1.6
Net profit after tax	8.0	9.5	18.1	1.1

(a) The six months to March for ANZ Banking Group, National Australia Bank, St George Bank and Westpac Banking Corporation; and the six months to June for Commonwealth Bank of Australia

(b) Annualised half-year results

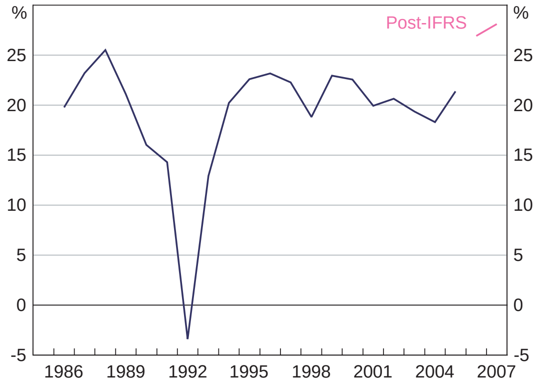
(c) Before outside equity interests

Sources: Banks' annual and interim reports

Graph 25

Profit before Tax*

Return on shareholders' funds, five largest banks**

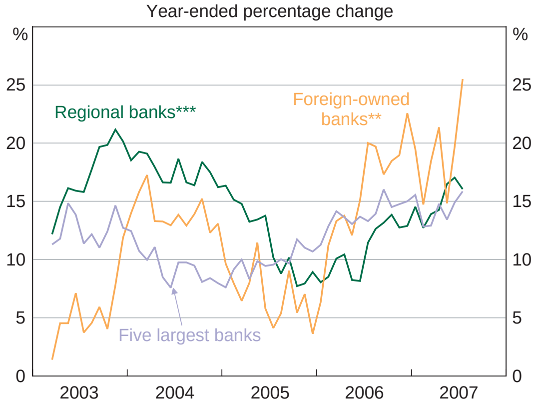


* 2007 data are annualised half-year results. From 2006 data are on an IFRS basis; prior years are on an AGAAP basis.
** Four largest banks only prior to 1993.
Sources: Banks' annual and interim reports

Graph 26

Banks' Assets*

Year-ended percentage change



* Domestic books basis, excludes intra-group assets and equity investments in related entities
** Adjusted for bank entries and exits
*** Adelaide Bank, Bank of Queensland, Bendigo Bank and Suncorp-Metway
Source: APRA

banks growing particularly strongly (Graph 26).

The effect of lending growth on bank profits has been partly offset by declining interest margins. The ratio of net interest income to average interest-earning assets for the five largest banks fell by a further 6 basis points in the latest half year, to 2.2 per cent (compared with 3.9 per cent in the mid 1990s) (Graph 27). For much of the past decade, the effect of declining margins on profitability has been partly countered by a rising share of income from wealth management operations. This form of income rose by 21 per cent over the past year, underpinned by solid growth in funds under management, and now accounts for nearly 15 per cent of the five largest banks' total income, compared with 9 per cent five years ago. Growth in profits has also been supported by slower growth in costs than in assets, with the aggregate cost-to-income ratio falling further in the latest half year, to 45 per cent. Banks have also benefited from a decline in bad debts expense over recent years to very low levels, although the declining trend seen since 2001 appears to have come to an end, largely due to a modest increase in bad debts expense for household loans (see below). Over the most recent years, the ratio of bad debts expense to total loans was 0.2 per cent, around half the level seen earlier this decade (Graph 28).

Credit Risk and Capital Adequacy

Credit Risk

In aggregate, the asset quality of Australian banks remains sound. As at June 2007, the ratio of banks' non-performing assets to on-balance sheet assets stood at 0.5 per cent, a slight increase over the past six months, but still low by historical and international standards (Graph 29). Of these non-performing assets, less than half are classified as 'impaired' – that is, repayments are in arrears (or otherwise doubtful) and the amount owed is not well covered by collateral.

The remainder are considered to be well covered by collateral, though payments are in arrears by 90 days or more.

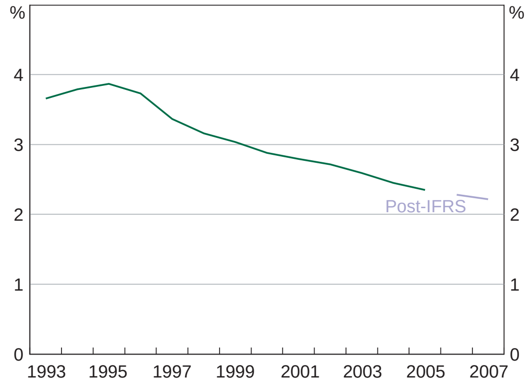
The modest increase in non-performing assets is largely accounted for by a rise in the ratio of non-performing housing loans to total housing loans. In aggregate, 0.41 per cent of housing loans on banks' domestic balance sheets were non-performing as at June 2007, up from the very low level of 0.2 per cent four years ago (Graph 30). Around three quarters of these loans are considered by banks to be well covered by the value of collateral. While almost all banks have experienced an increase in non-performing housing loans, the increases have been most pronounced for the foreign-owned and regional banks (Graph 31). This is consistent with the relatively rapid growth of lending by these banks in recent years which, in some cases, has been associated with lending to more marginal borrowers than in the past.

The arrears rate on business loans has also picked up slightly over the past six months, although, at 0.95 per cent as at June 2007, it remains low, and below the average of recent years. Problem loans in banks' commercial property portfolios are also low, with only 0.2 per cent of outstanding commercial property loans classified as impaired as at March 2007. This compares with 1.9 per cent in 1997, and a much higher figure in the early 1990s (Graph 32).

Graph 27

Net Interest Income*

Per cent of average interest-earning assets, five largest banks

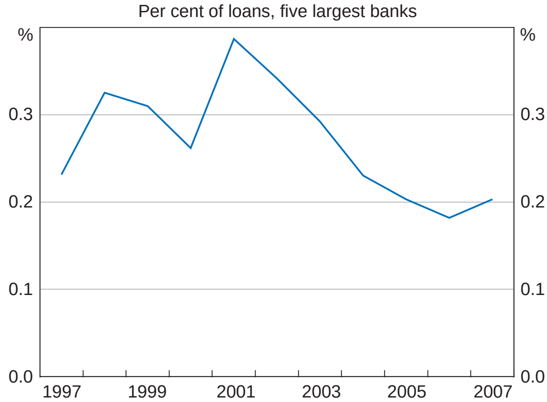


* 2007 data are annualised half-year results. From 2006 data are on an IFRS basis; prior years are on an AGAAP basis.
Sources: Banks' annual and interim reports

Graph 28

Charge for Bad and Doubtful Debts*

Per cent of loans, five largest banks

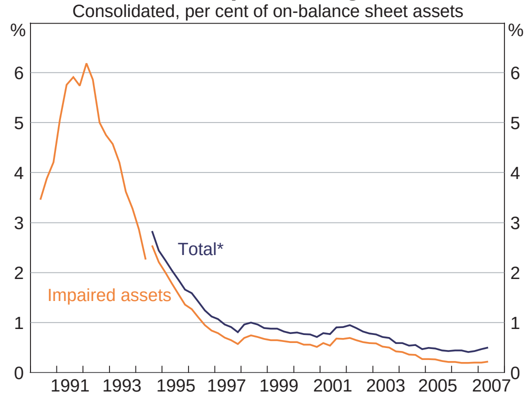


* 2007 data are annualised half-year results. From 2006 data are on an IFRS basis; prior years are on an AGAAP basis.
Sources: Banks' annual and interim reports

Graph 29

Banks' Non-performing Assets

Consolidated, per cent of on-balance sheet assets

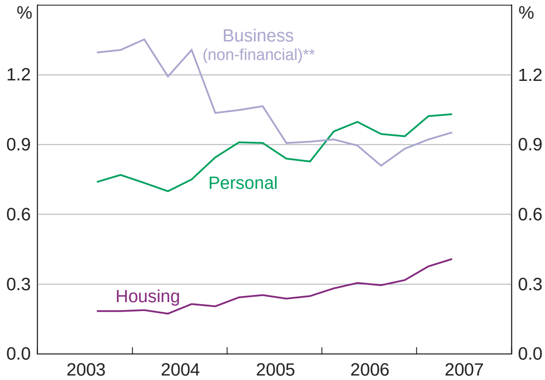


* Includes 90+ days past-due items that are well secured
Source: APRA

Graph 30

Banks' Non-performing Loans*

Domestic books, per cent of outstandings by loan type

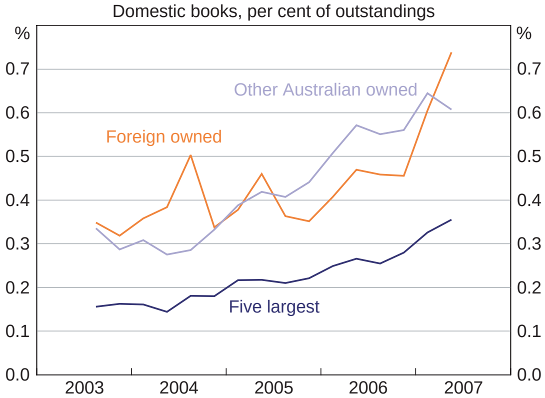


* Includes 90+ days past-due items that are well secured
** Includes bill financing
Source: APRA

Graph 31

Non-performing Housing Loans by Bank Type*

Domestic books, per cent of outstandings

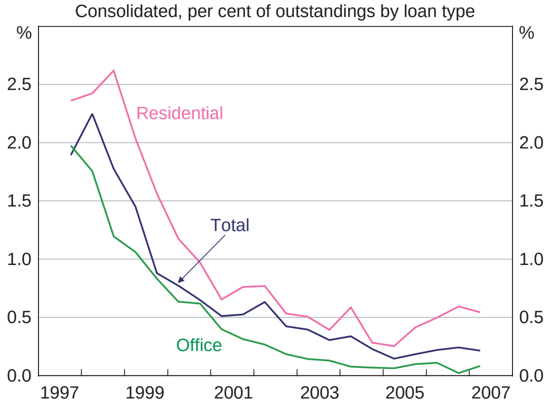


* Includes 90+ days past-due items that are well secured
Source: APRA

Graph 32

Banks' Commercial Property Impaired Assets

Consolidated, per cent of outstandings by loan type



Source: APRA

Banks are also exposed to credit risk through their operations overseas. Total foreign exposures grew by 9 per cent over the six months to June 2007, largely due to an ongoing expansion of activities in New Zealand and the United Kingdom (Table 2). These two countries account for 45 per cent and 25 per cent of total foreign exposures, respectively, mainly reflecting the activities of Australian branches and subsidiaries rather than cross-border lending. Exposures to the United States account for a further 10 per cent of foreign claims, with Australian banks' US-located operations focusing on institutional and business banking, rather than lending to the household sector. More generally, Australian banks have only minimal exposures to the US sub-prime mortgage market and any exposures are generally through indirect channels, such as lines of credit to funding vehicles.

Capital Adequacy

Australian banks and other ADIs remain well capitalised. The aggregate capital ratio for the banking system has fluctuated in a narrow range over the past decade or so, and stood at 10.4 per cent as at June 2007 (Graph 33). The aggregate capital ratio of the credit union sector has increased over recent years and is around 16 per cent, while the aggregate ratio of the building society sector has fallen slightly, to 13.5 per cent.

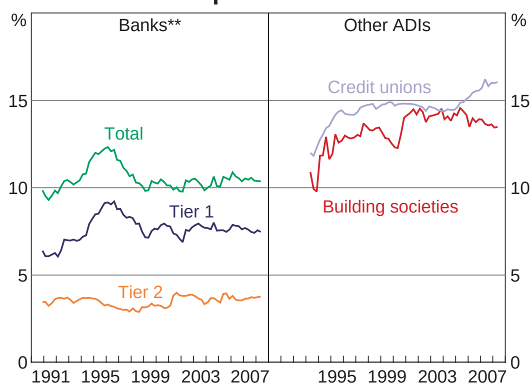
For banks, the Tier 1 capital ratio has been broadly stable for

Table 2: Australian-owned Banks' Foreign Exposures
June 2007, ultimate risk basis

	Total		of which:	
	Level	Share	Cross-border	Local
	$b	Per cent	$b	$b
New Zealand	212.2	44.5	5.8	206.4
United Kingdom	116.6	24.5	25.7	90.9
United States	48.3	10.1	31.6	16.7
Other developed countries	64.3	13.5	59.0	5.4
Developing countries	18.9	4.0	10.9	8.0
Offshore centres[(a)]	15.7	3.3	10.3	5.3
Other	0.5	0.1	0.4	0.1
Total	**476.5**	**100.0**	**143.7**	**332.8**
Memo: Per cent of total assets	*29.4*		*8.9*	*20.5*

(a) Includes Hong Kong and Singapore
Source: APRA

Graph 33
Capital Ratios*



* Per cent of risk-weighted assets
** Locally incorporated banks (consolidated)
Source: APRA

some time, at 7.5 per cent, and remains well above international minimum requirements. There has, however, been a slight change in the composition of Tier 1 capital in recent years, with an increasing share accounted for by innovative capital instruments, including hybrid securities (Graph 34). The Tier 2 capital ratio has increased slightly in recent years, largely due to term subordinated debt increasing at a faster rate than risk-weighted assets. As discussed in the *Developments in the Financial System Infrastructure* chapter, the combination of APRA's revised capital adequacy framework – which comes into effect from 1 January 2008 – and the recent changes to accounting standards is likely to affect the composition of capital going forward. Among other things, these changes will impose limits on banks' use of innovative hybrid funding instruments, though an additional two-year transition period may be available for banks that are affected by this change.

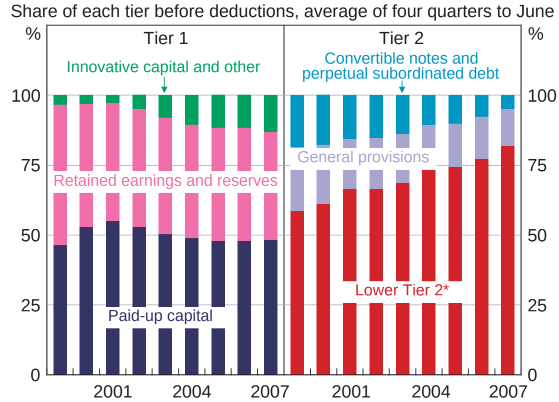
Market Risk

Australian banks have traditionally had only small unhedged positions in financial markets. This is demonstrated by the fact that the value-at-risk – which measures the potential loss, at a given confidence level, over a specified time horizon – for the four largest banks has been broadly stable at around 0.05 per cent of shareholders' funds for the past five years. Consistent with this low exposure to market risk, Australian banks are not heavily reliant on trading income

Graph 34

Components of Banks' Capital

Share of each tier before deductions, average of four quarters to June

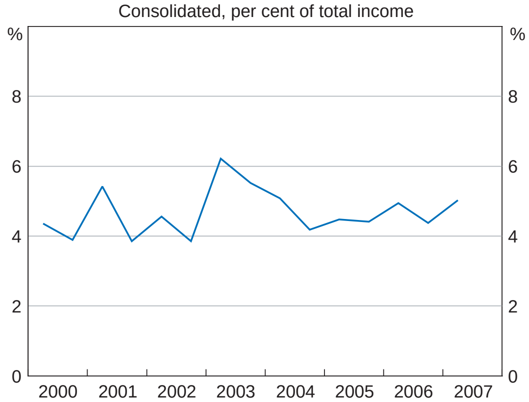


* Mainly term subordinated debt, but can include other approved instruments
Source: APRA

Graph 35

Banks' Trading Income*

Consolidated, per cent of total income



* Four largest banks
Sources: Banks' annual and interim reports

for profitability. This form of income accounted for only around 5 per cent of total operating income of the four largest Australian banks in the latest half year, which is considerably lower than for some of the large globally active banks (Graph 35).

Notwithstanding this low exposure, banks have been very active in the growth of derivative markets, which they use both to provide risk-management services to their clients as well as to manage risks on their own balance sheets. An indication of the overall growth in banks' derivatives activity is provided by the gross notional principal value of their outstanding derivatives, which has risen from a little over $2 trillion in the mid 1990s to $12 trillion as at June 2007 (Graph 36).

Recent events in credit markets have focused attention globally on banks' use of credit derivatives in particular. In Australia, this market remains relatively small by international standards, despite rapid growth over the past few years. According to the Australian Financial Markets Association, there was $77 billion of credit derivatives outstanding in the Australian market as at June 2006, with banks accounting for around two thirds of annual turnover in this market. Despite this, credit derivatives account for only a small share – around 1 per cent – of banks' outstanding derivatives positions.

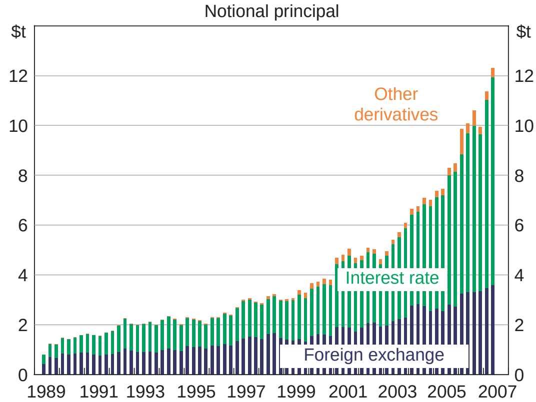
Lending and Competition

As noted above, recent events in credit markets are leading to higher funding costs for financial intermediaries, with the increases being greatest for those intermediaries that rely on securitisation markets. To the extent that this differential impact on funding costs is sustained, as seems probable, it is likely to have an impact on competition in the mortgage market over the period ahead. Over recent years, this competition has led to a marked contraction in loan margins and significant changes in lending practices, including: an increase in permissible debt-servicing ratios; an increased reliance on brokers to originate loans; the wider availability of low-doc loans; and an increase in allowable loan-to-valuation ratios. As a result of this competition, the vast majority of new full-doc borrowers over recent years have been charged an interest rate less than the major banks' standard variable home loan indicator rate, with discounts of 70 basis points having become common. The strong competition has also been reflected in a high rate of refinancing, which has led to sustained pressure on margins on banks' *outstanding* housing loans.

Graph 36

Banks' Derivatives

Notional principal



Source: APRA

The pressures on margins over recent years have been especially strong in the low-doc market. Late last year, the interest rate on new low-doc loans was, on average, around 20 basis points higher than the average rate on full-doc loans, compared with 90 basis points in late 2002. This meant that the average interest rate on low-doc loans was around 45 basis points below the major banks' standard variable indicator rate, whereas earlier in the decade it was common for lenders to charge a premium over the indicator rate for these loans. Currently, low-doc loans account for around 10 per cent of new housing loans, though this share is significantly higher for some non-bank lenders and some smaller ADIs (Table 3).

Table 3: Housing Loans

	Per cent of approvals				Per cent of outstandings
	2000	2002	2004	2006	2007
Prime loans					
Full-doc	>99	96	88½	88	92
Low-doc	<½	3	10	10	7
Non-conforming loans	<½	1	1½	2	1

Sources: ABS; banks' annual reports; RBA; Standard & Poor's

One factor that sustained this competition was the narrowing of spreads on residential mortgage-backed securities. The willingness of investors to purchase these securities at ever finer spreads allowed lenders that rely on securitisation for their funding to offer lower interest rates to borrowers. The global repricing of risk is putting upward pressure on these funding costs. A number of lenders in the low-doc market that rely heavily on securitisation markets have already responded to the higher funding costs, increasing their rates on low-doc loans, not just for new borrowers, but also for existing borrowers. Lenders that rely on more traditional and diversified sources of funding have felt less immediate need to increase their rates and, in at least one case, have sought to expand their low-doc lending portfolio.

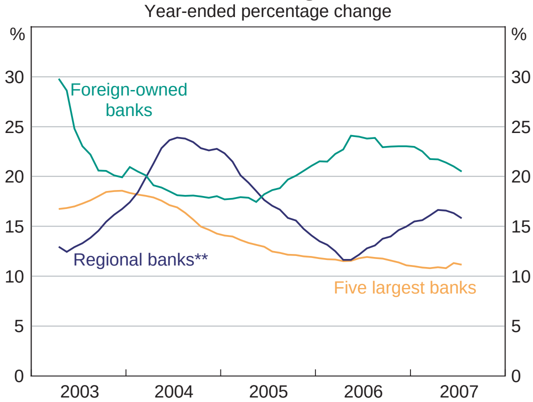
The higher funding costs have also caused a number of providers of non-conforming loans (the closest equivalent to the US sub-prime mortgage market) to increase their rates by more than the recent 25 basis point rise in the cash rate; the three largest non-conforming lenders (all non-ADIs), which account for over 70 per cent of the market, have increased their rates by up to 90 basis points. The market for non-conforming loans in Australia remains small, with this form of lending accounting for only around two per cent of new housing loans in 2006, and one per cent of outstanding loans; specialised non-bank lenders account for almost all of these loans.

While lower funding costs have been an important factor promoting competition in the Australian financial system over recent years, another factor has been the increased activity of foreign-owned banks in the retail market.[1] This activity has been facilitated, in part, by the more widespread distribution of banking services via the internet. In the late 1990s, foreign-owned banks introduced high-yield online savings accounts, significantly increasing competition in deposit markets. Initially, the major Australian banks were reluctant to offer such accounts, although they all have done so over recent years and there is now a wide variety of online accounts that pay an interest rate at, or close to, the cash rate. Foreign-owned banks have also recently added to competition in the mortgage market, with these banks experiencing above-average growth in housing credit and one foreign-owned bank recently announced plans to significantly expand its branch network (Graph 37).

Graph 37

Banks' Housing Credit*

Year-ended percentage change



* Including securitisation, adjusted for some series breaks
** Adelaide Bank, Bank of Queensland, Bendigo Bank and Suncorp-Metway
Sources: APRA; RBA

Strong competition has also been evident over recent years in the personal lending market, especially in credit cards. Most issuers, including the five largest banks, now offer low-rate cards with interest rates in the range of 9 to 14 per cent, compared with 17½ per cent on traditional cards. Reflecting the competition from smaller institutions – including non-banks and foreign-owned banks – the market share of the five largest banks has fallen to around 72 per cent of outstanding credit card debt, from nearly 85 per cent five years ago. As discussed in the *Household and Business Balance Sheets* chapter, margin lending is another component of personal credit that has grown particularly strongly of late. This reflects not only the generally strong performance of the equity markets, but also the stronger competitive environment which has seen an increase in the range of securities eligible for purchase with a margin facility, and an increase in the maximum allowable loan-to-valuation ratio on 'blue chip' shares from around 70 per cent to 75 per cent.

1 *For more details see Reserve Bank of Australia (2007) 'Box C: Foreign-owned Banks in Australia',* Financial Stability Review, *March.*

Another notable characteristic of the recent competitive environment has been an increase in competitive pressures in the business loan market. Bank business credit grew by 20 per cent over the year to July 2007, compared with 13 per cent growth in bank credit (including securitisation) to households (Graph 38). Growth has been strongest in loans with a value greater than $2 million, with the total value of these loans increasing by around 31 per cent over the past year, and now accounting for around two thirds of total business loans outstanding. Average spreads on these large loans have also continued to fall over recent years, while spreads on smaller loans have changed little.

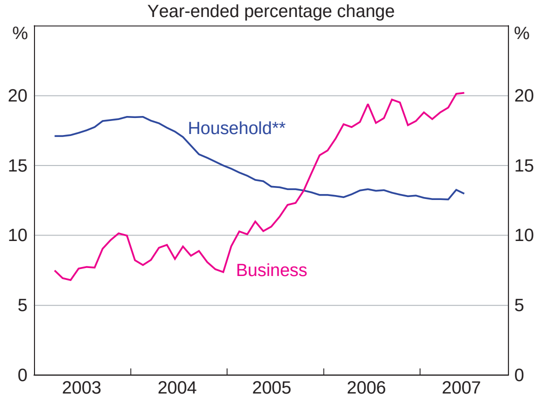
The rapid growth of large-sized loans is consistent with a significant amount of business debt having been raised in the syndicated loan market. A record $124 billion of syndicated loans were approved in 2006/07, an increase of 48 per cent compared with the previous year (Graph 39). Refinancing accounted for just under 40 per cent of syndicated loan approvals over the past two years, compared with an average of 30 per cent over the preceding decade, suggesting that borrowers have taken advantage of the favourable funding conditions during this period to obtain more attractive rates. A further 26 per cent of syndicated loans approved in the past year were to finance mergers and acquisitions.

As noted in the previous *Review*, competition in business lending has been spurred by a number of factors, including the activities of some more recent entrants into the market. Foreign-owned banks, for example, increased their share of total bank business loans outstanding to 21 per cent as at June 2007 from 17 per cent two years ago, after a couple of years of below-average growth. The recent increase reflects the prominence of foreign-owned banks in the market for large-value business loans, with their share of this segment rising to around 28 per cent (Graph 40).

Graph 38

Bank Credit*

Year-ended percentage change

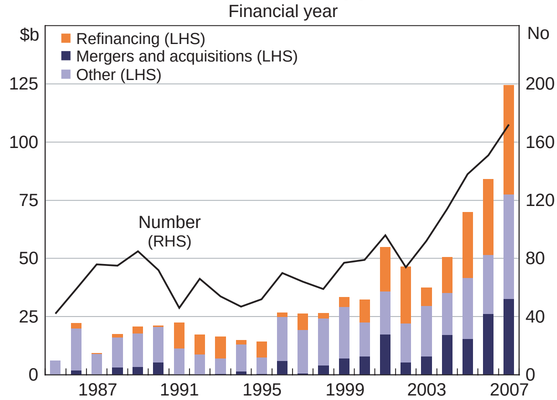


* Adjusted for some series breaks
** Including securitisation
Source: RBA

Graph 39

Syndicated Loan Approvals

Financial year

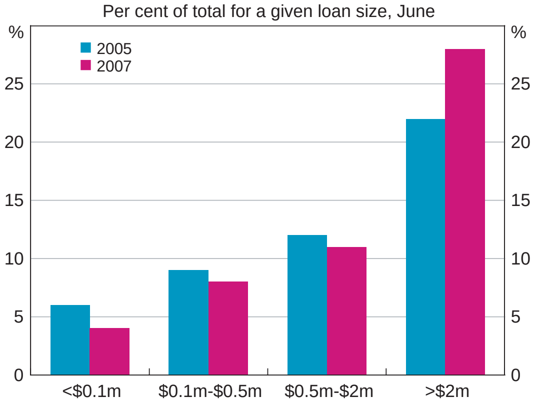


Sources: RBA; Thomson Financial

In the market for smaller-value business loans, an important contribution to the increase in competition has been the growth of business loan brokers. Although precise data are unavailable, Graph 40

Foreign Banks' Business Loans Outstanding

Per cent of total for a given loan size, June



Source: APRA

indications are that broker-originated lending has grown strongly recently, albeit from a low base, with some observers estimating that more than 20 per cent of SMEs now access finance through this channel. At the same time, banks are making greater use of automated approval systems for certain types of loans in order to help streamline the processing of business loans. Banks have also increased the number of business banking staff in recent years.

At this stage it is too early to fully assess the impact of the recent credit market turbulence on business lending growth and competition. There is, however, likely to be some tightening of the very favourable funding terms enjoyed by businesses in recent years.

Credit Ratings

Throughout the recent turbulence, rating agencies have continued to take a positive view of Australian banks, having issued a number of statements to this effect. The four largest banks were upgraded by Standard & Poor's in February to AA, from AA- (Table 4). Internationally, very few banks of a similar size have higher credit ratings. Moody's has also maintained its financial strength ratings of the Australian banks which, unlike long-term credit ratings, do not take account of the possibility of external support. As discussed above, this is consistent with the sound underlying condition of Australian banks, with problem loans remaining low by historical and international standards, and profitability having been very strong for more than a decade.

General Insurers

The general insurance industry, in aggregate, remains highly profitable. Pre-tax return on equity was 27 per cent in the 2006/07 financial year and, while this was slightly lower than in the previous year, it was above its decade-average of 14 per cent (Graph 41).

Insurers have continued to benefit from a relatively favourable claims environment. Aggregate claims increased by only around 2 per cent in the latest financial year, notwithstanding estimated insured losses in excess of $1 billion from the severe storms that hit coastal New South Wales in June. Reflecting this, the combined ratio – claims and underwriting expenses relative to net premium revenue – has remained relatively stable and stood at 84 per cent over the year to June 2007.

The general insurance industry, in aggregate, continues to hold capital considerably in excess of regulatory minima. As at June 2007, domestic general insurers had aggregate net assets of twice the regulatory minimum. They generally have a conservative investment approach with

Table 4: Long-term Ratings of Australian Banks
As at 20 September 2007

	Current	Last change: Direction	Last change: Date
Adelaide Bank	BBB+	↑	October 2004
AMP Bank	A-	↑	July 2004
ANZ Banking Group	AA	↑	February 2007
Arab Bank Australia	A-	–	January 2007
Bank of Queensland	BBB+	↑	April 2005
BankWest	AA-	↑	August 2006
Bendigo Bank	BBB+	↑	February 2005
Commonwealth Bank of Australia	AA	↑	February 2007
Elders Rural Bank	BBB	↑	August 2007
HSBC Bank Australia	AA	↑	August 2006
ING Bank (Australia)	AA	↑	August 2005
Macquarie Bank	A	–	November 1994
National Australia Bank	AA	↑	February 2007
St George Bank	A+	↑	January 2006
Suncorp-Metway	A+	↑	March 2007
Westpac Banking Corporation	AA	↑	February 2007

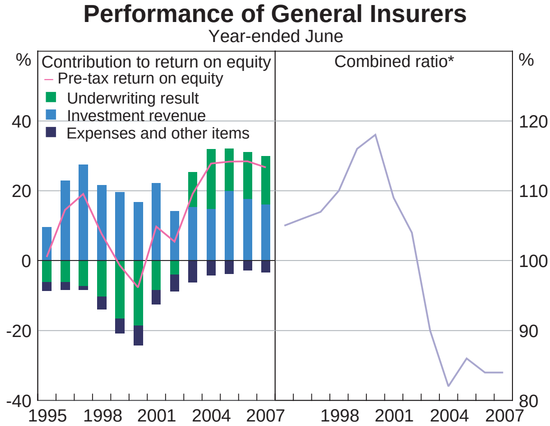
Source: Standard & Poor's

70 per cent of their total investments held in fixed interest or similar assets. The main providers of lenders' mortgage insurance have strong capital positions and appear to be well placed to absorb any further rise in claims.

Competitive pressures have also been evident to some extent in the general insurance industry in recent years, with premiums in commercial insurance lines having been under downward pressure. In personal insurance lines, industry analysts generally expect modest increases in premiums in the period ahead.

Graph 41

Performance of General Insurers

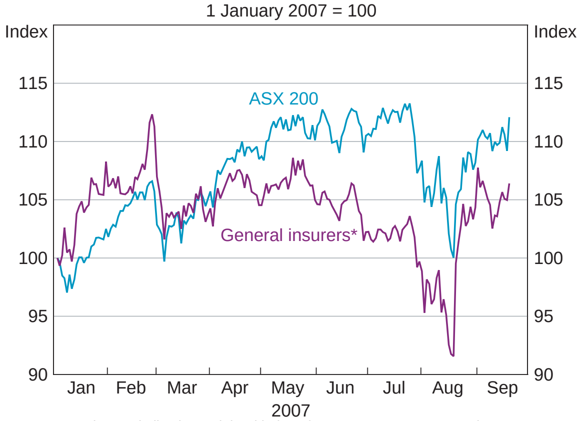


* Claims and underwriting expenses as a per cent of net premium revenue
Sources: APRA; ISC

Ratings agencies also continue to hold a favourable view of the general insurance industry, with Standard & Poor's upgrading Allianz Australia by one notch, to AA-, in July and Suncorp-Metway Insurance by one notch, to A+ in March. The financial strength ratings of the four largest general insurers are all A+ or higher. Share prices of the major Australian general insurers fell noticeably around the middle of the year, in part, reflecting some downgrades to the profit

Graph 42

General Insurers' Share Prices



* Market capitalisation weighted index of IAG, Suncorp-Metway and QBE
Sources: Bloomberg; RBA

outlook following the June storms in New South Wales and a number of firm-specific factors. Recently, insurers' share prices have risen by slightly more than the broader market, and are now around 6 per cent higher than at the beginning of the year (Graph 42).

Global reinsurers – which absorb some of the risk from domestic insurers – have faced a more favourable claims environment recently, after the sector experienced record natural catastrophe losses in 2005. Although it is still too early to gauge the full impact of the heavy flooding in the United Kingdom in June and July, some of the largest global reinsurers have recently reported strong profit results and are well placed to deal with a rise in claims.

Wealth Management

The wealth management industry continues to grow strongly, with total consolidated assets increasing by 22 per cent over the year to June 2007, to stand at $1.3 trillion (Table 5). Superannuation funds, which account for nearly 60 per cent of total assets, expanded their funds under management by 28 per cent over the year to June. In recent years, superannuation funds have benefited from both strong investment returns and, as discussed in the *Household and Business Balance Sheets* chapter, increased inflows of new funds.

Life insurers' assets under management grew by 11 per cent over the year to June 2007, with these institutions accounting for 17 per cent of total assets of the wealth management industry. In contrast to the previous three years, net insurance flows (premiums and contributions less

Table 5: Assets Under Management
Consolidated, June 2007

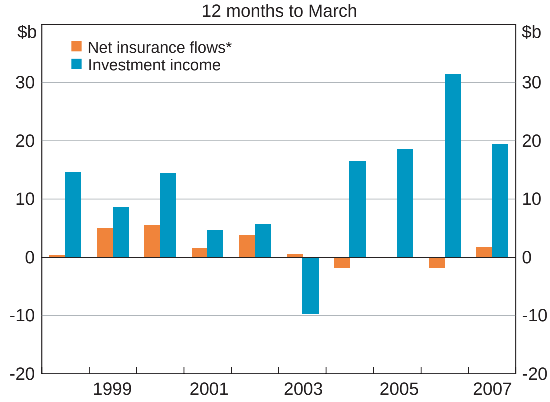
	Level	Share of total	Year-ended growth
	$b	Per cent	Per cent
Superannuation funds	780.7	58.5	28.0
Life insurers[(a)]	224.5	16.8	10.5
Public unit trusts	267.0	20.0	17.9
Other managed funds[(b)]	62.4	4.7	17.7
Total	**1334.7**	**100.0**	**22.2**
Memo: total superannuation assets[(c)]	972.6	72.9	24.4

(a) Includes superannuation funds held in the statutory funds of life insurers.
(b) Cash management trusts, common funds and friendly societies.
(c) Superannuation funds plus an estimate of the superannuation assets held in the statutory funds of life insurers.
Sources: ABS; RBA

policy payments) made a small positive contribution to asset growth (Graph 43). Nonetheless, investment income continues to account for the vast bulk of life insurers' asset growth. The strong growth in investment income in recent years largely reflects the performance of share markets, with life insurers currently investing around 50 per cent of their statutory fund assets in Australia in equities and units in trusts, compared with around 30 per cent a decade ago. As such, the future performance of life insurers is likely to be closely linked to movements in equity markets. With only 10 per of life office assets now related to writing life risk insurance, prospects for this sector are heavily tied to developments in superannuation.

Graph 43

Performance of Life Insurers



* Premiums and contributions minus policy payments
Source: APRA

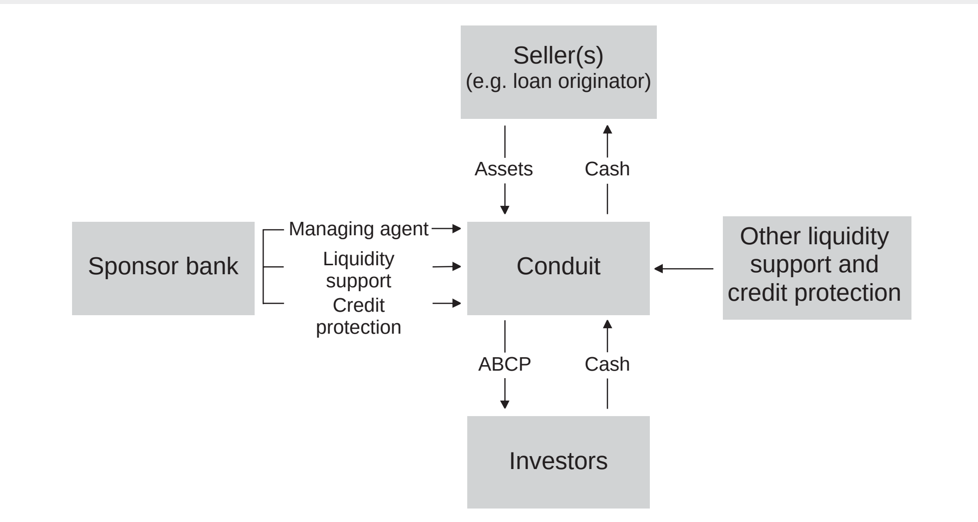
Outside of superannuation funds and life offices, the vast bulk of funds under management are invested in public unit trusts, which grew by nearly 18 per cent over the year to June 2007. This growth largely reflected the performance of equity trusts and listed property trusts.

Box A: The Australian Asset-backed Commercial Paper Market

The recent turbulence in global financial markets has focused attention on the links between banks and the asset-backed commercial paper (ABCP) market.

ABCP – which typically has a term to maturity of between 30 days and one year – is issued by so-called conduits in order to finance the purchase of financial assets, including mortgages, receivables and securities (particularly residential mortgage-backed securities (RMBS)) from a variety of 'sellers', including loan originators. Conduits are usually set up, or 'sponsored', by a bank, though the conduit is a legally separate, 'bankruptcy remote', entity.[1] The sponsor provides administration services and, as discussed below, also often provides liquidity support to the conduit as well as some form of credit enhancement. Figure 1 shows a stylised representation of a conduit structure.[2]

Figure 1: Conduit Structure



Conduits can be used for a number of purposes. In some cases, they are used to temporarily 'warehouse' mortgages, until the pool of mortgages is of sufficient size for an RMBS to be issued. Loans temporarily financed in this way can be originated either by the sponsor of the conduit, or by third parties, including both bank and non-bank lenders. Conduits can also be used for longer-term financing of mortgages, although this form of financing entails significant roll-over risk (see below). Conduits are also used for the financing of a wide variety of other

1 *Under a bankruptcy remote structure, the solvency of the conduit is independent of the sponsor (and the sellers).*

2 *Although not shown in Figure 1, it is common for assets to be held in an additional special purpose vehicle, in which the conduit either acquires an interest or provides a loan.*

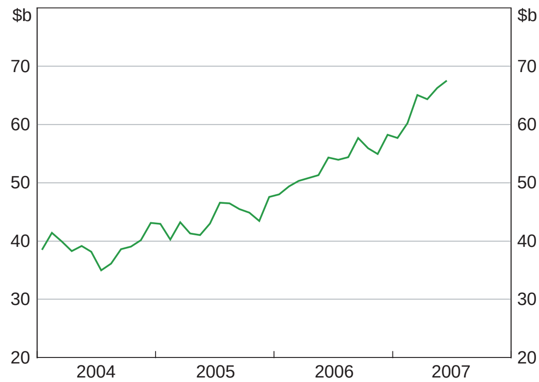
assets, including margin loans and vehicle leases that typically have much shorter maturities than mortgages and RMBS.

The Australian ABCP market has grown strongly in recent years, although it remains relatively small compared with that in many other countries. Based on programs rated by Standard & Poor's, it is estimated that the value of outstanding ABCP almost doubled over the past three years, to around $68 billion as at June 2007 (Graph A1).[3] Around half of the outstanding ABCP had been issued onshore, with most of the remainder issued in the United States, and a small share in the European market. In total, it is estimated that there are 560 pools of assets backing around 60 different ABCP programs.

Graph A1

Australian ABCP Outstanding

Issued onshore and offshore



Source: Standard & Poor's

Of the ABCP outstanding, over 80 per cent had been issued by 'multi seller' conduits, which, as the name suggests, buy assets from a number of different originators. Within a multi-seller structure, individual ABCP issues can either be backed by the conduit's entire pool of assets, or by specified assets within the total pool; the latter type of ABCP is known as a segregated issue.

According to data from Standard & Poor's, around 45 per cent of the underlying collateral for Australian ABCP is residential mortgages, and a further 17 per cent is RMBS (Table A1). Only a small share of these loans was non-conforming (2 per cent) and, according to Standard & Poor's, Australian ABCP has little, if any, exposure to US sub-prime mortgages or collateralised debt obligations backed by US sub-prime RMBS. The ABCP backed by residential mortgages accounts for just 3½ per cent of the value of Australian housing loans; in comparison, longer-term RMBS account for around one quarter of total housing loans.

The credit quality of ABCP is potentially higher than that of the assets which back it. This is because most ABCP programs have credit enhancement which protects investors against default on the underlying assets. Reflecting this, ABCP is generally highly rated – around 80 per cent of outstanding ABCP is rated 'A-1+' by Standard & Poor's, the highest rating available. Credit enhancement can be transaction-specific or program-wide. Many conduits use a combination of both; the transaction-specific enhancement usually provides first-loss protection ahead of the program-wide enhancement. Transaction-specific credit enhancement provides protection on a specific asset pool and cannot be used to cover losses on the rest of the

3 *These data do not include programs that are privately placed or unrated. Note that the value of the collateral underlying the outstanding ABCP is slightly higher.*

Table A1: Collateral Underlying Outstanding ABCP
June 2007

	$ billion	Per cent of total
Residential mortgages	32.9	45
of which:		
Prime	32.1	44
Non-conforming	0.8	1
Residential mortgage-backed securities	12.3	17
of which:		
Prime	11.6	16
Non-conforming	0.7	1
Auto/equipment loans & leases	4.8	7
Equities	4.2	6
Margin loans	4.0	6
Infrastructure bonds	3.9	5
Small business loans	2.1	3
Trade receivables	2.1	3
Commercial mortgage-backed securities	1.7	2
Collateralised debt obligations	1.4	2
Corporate bonds & loans	0.6	1
Credit card receivables	0.5	1
Other	2.0	3
Total	**72.5**	**100**

Source: Standard & Poor's

conduit's portfolio of assets. Often it is provided by over-collateralisation of the asset pool, commonly 10 per cent. Program-wide credit enhancement is frequently provided by the sponsoring bank in the form of a letter of credit (often equal to 10 per cent of the ABCP). At times, it may also be provided by the issuance of subordinated notes that absorb losses first. When ABCP is backed by highly-rated securities, rather than loans or receivables, the program usually does not have additional credit enhancement, though the underlying securities may be highly rated because of their own credit enhancement, through subordination and/or lenders' mortgage insurance.

The term to maturity of ABCP is usually less than the maturity of the underlying assets, so funding of the assets generally relies on the ability of the conduit to roll over its maturing paper, with the new paper being used to repay investors in the maturing paper. Given the roll-over risk, most conduits have back-up lines of credit, which typically cover the full value of the maturing ABCP. These back-up arrangements are often provided by the sponsor, but third parties are also sometimes involved. According to Standard & Poor's, $24 billion (or 37 per cent) of the liquidity facilities for rated Australian conduits were provided by the four largest Australian-owned banks as at June 2007; the remainder were largely provided by branches of foreign-owned banks operating in Australia.[4]

An alternative to the back-up lines is to issue paper with an option to extend the maturity if the conduit is unable to roll over the paper. Once the paper is extended, the issuer pays a higher rate (often an extra 25 basis points) to the current holders and the paper is repayable by a fixed maturity date, normally in less than 270 days. This alternative arrangement is in place

4 *It is worth noting that these figures understate the overall exposure of Australian banks to conduit vehicles, as banks also provide liquidity support to conduits not captured in the Standard & Poor's data, such as foreign conduits and unrated programs.*

for only around 10 per cent of Australian ABCP, and most extendible ABCP has been issued in the United States.

There are a number of potential issues raised by the back-up lines of credit associated with the ABCP market.

One is that the provider of the credit line needs to maintain sufficient liquidity to be able to meet its commitment at short notice; in most cases, funds are required to be available on a same-day basis. In the current environment, the possibility that further liquidity will need to be provided to ABCP programs has meant that some banks have taken a conservative approach to their own liquidity management.

A second issue is that the provision of back-up liquidity facilities exposes the provider to the credit risk of the underlying assets, given that these facilities are secured by the underlying assets, or may even take the form of purchasing the assets.

A third issue is the potential effect of a drawdown on the capital requirements of the provider. Standby lines of credit are recorded by banks as an off-balance sheet exposure, and under Basel I do not attract a regulatory capital charge if the term to maturity is less than one year, which is normally the case. However, when the facility is drawn, a regulatory capital requirement applies. The impact on overall regulatory capital is, however, likely to be manageable. By way of example, the $24 billion in lines of credit provided by the four largest banks is equivalent to only 2 per cent of their $1 100 billion of risk-weighted assets as at June 2007. Accordingly, if these lines of credit were all drawn, the aggregate capital ratio for these four banks could be reduced by up to 20 basis points.

Household and Business Balance Sheets

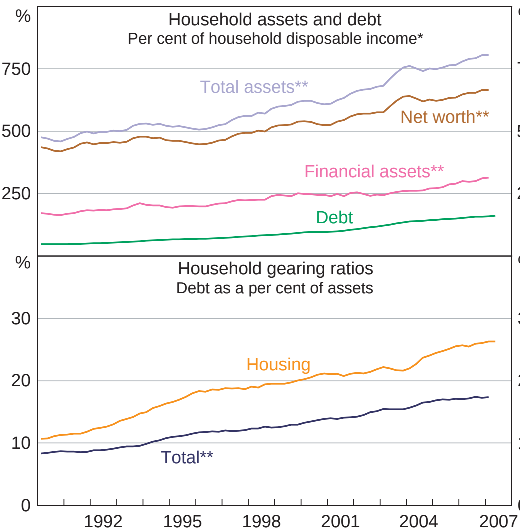
As discussed in the most recent *Statement on Monetary Policy*, the Australian economy is continuing to grow at a strong pace, which is contributing to favourable conditions in the household and business sectors. Overall, household and business balance sheets remain in good shape. While the share of households experiencing difficulties meeting their debt obligations has risen over recent years, this share remains relatively low. Moreover, a number of indicators suggest that the rate of increase in households experiencing difficulties has slowed in the past year or so, which is consistent with the continuing strong growth in employment and firmer housing markets in many parts of the country. While leverage among businesses has increased over the past couple of years, debt-servicing requirements and arrears rates remain low, in part due to the ongoing strength in profitability.

Household Sector

As has been discussed in previous *Reviews*, household balance sheets in Australia have expanded significantly since the early 1990s, with a substantial rise in the value of both debt and assets relative to household disposable income (Graph 44). Over this period, the net worth of the household sector has also risen significantly, from the equivalent of about 4½ times annual income to a little over 6½ times income.

Graph 44

Household Balance Sheets



* Income is after tax and before the deduction of interest payments; includes income of unincorporated enterprises in all ratios except for household debt to income

** Includes financial assets of unincorporated enterprises

Sources: ABS; RBA

The strong growth in household balance sheets has continued in recent years, with debt rising by around 13 per cent and assets by 11 per cent over each of the past two years. Moreover, the fact that the value of assets significantly exceeds the value of liabilities means that, despite the latter growing more quickly, household net worth has increased at an average rate of 11 per cent over these two years, slightly above the long-run average rate of increase. Aggregate gearing of the household sector – the ratio of debt to assets – has also continued to rise, to stand at 17½ per cent at the end of March 2007, an increase of 5½ percentage points over the past decade. Despite this increase, household gearing remains lower than in many comparable countries.

Over the year to March 2007, the latest period for which relevant data are available, the value of households' holdings of financial assets increased by 13 per cent, compared with an

Table 6: Household Assets
Per cent

	Share of total	Year-ended growth	
	March 2007	March 2006	March 2007
Non-financial assets	60.9	7.3	10.4
Dwellings	56.7	7.5	10.8
Consumer durables	4.2	4.5	5.0
Financial assets[(a)]	39.1	18.0	12.9
Superannuation and life offices[(b)]	21.8	20.4	15.3
Shares and other equities	7.6	21.9	13.5
Currency and deposits	7.8	9.2	10.3
Other	1.8	17.7	-3.8
Total	**100.0**	**11.2**	**11.3**

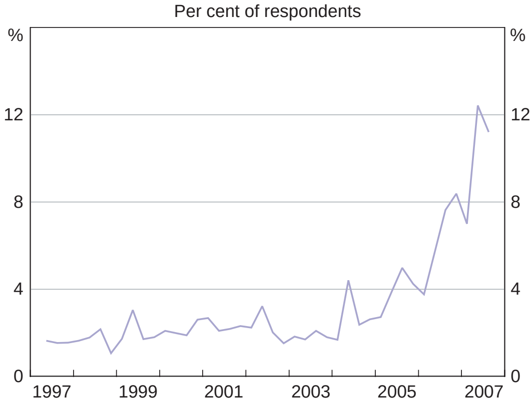
(a) Includes assets of unincorporated enterprises
(b) Includes unfunded superannuation
Sources: ABS; RBA

increase of 18 per cent in the previous year (Table 6). Growth continued to be underpinned by valuation gains resulting from generally buoyant equity markets, with the ASX 200 increasing by about 40 per cent over the past two years. There have also been significant inflows into financial assets, with net inflows into superannuation up by 22 per cent in the year to March. This increase is consistent with survey data which show a sharp rise over the past couple of years in the proportion of households that view superannuation as the preferred place for their saving (Graph 45). Although official data are not yet available, the superannuation industry has reported that there was a surge in contributions in the June quarter, as households took advantage of the one-off opportunity to make superannuation contributions of up to $1 million before lower limits on concessionally-taxed contributions were introduced. As well as switching from other financial assets, such as deposits, this increase in superannuation contributions appears to have been partly funded by increased borrowing, as discussed below.

After having been subdued for a couple of years, growth in the value of households' non-financial assets – mainly housing – has picked up recently, in line with the firmer tone in the housing market. Average nationwide house prices rose by 9 per cent over the year to the June quarter, double the average rate of growth over the previous two years (Table 7). Divergences in the rate of house price growth across the capital cities have also narrowed, with prices levelling out in Perth and picking up in most other cities. Most notably, average house prices rose by 3 per cent in Sydney over the past year, after falling over the previous two years. Disaggregated data indicate that the increases in Sydney are

Graph 45

Wisest Place for Savings: Superannuation
Per cent of respondents



Source: Westpac and Melbourne Institute

concentrated in the upper end of the market, where auction activity has strengthened recently, while house prices are still flat or declining in less expensive suburbs, particularly in the outer metropolitan area.

As noted above, on the liabilities side of the balance sheet, household debt also continues to grow solidly. Borrowing for housing, which accounts for the bulk of household debt, increased by 13 per cent over the year to July 2007, around the same as in the previous year. Growth in housing debt had slowed in the latter part of 2006 and into early 2007 but has since lifted, largely due to a pick-up in the demand for credit by investors (Graph 46). In six-month-ended annualised terms, growth in investor and owner-occupier housing credit is now broadly similar, following a couple of years in which growth in investor housing credit had been lower.

For much of the past year, demand for fixed-rate housing loans was relatively high, with almost one fifth of new owner-occupier housing loans in the year to July taken out at fixed interest rates, compared with 14 per cent in the previous year and a decade average of 11 per cent (Graph 47). While the stronger demand for fixed-rate loans reflects, in part, some borrowers' expectations about future movements in interest rates, it also reflects increased competition among lenders, with spreads to funding costs having narrowed. While the most common term for fixed-rate housing loans is still only

Table 7: House Prices
Percentage change

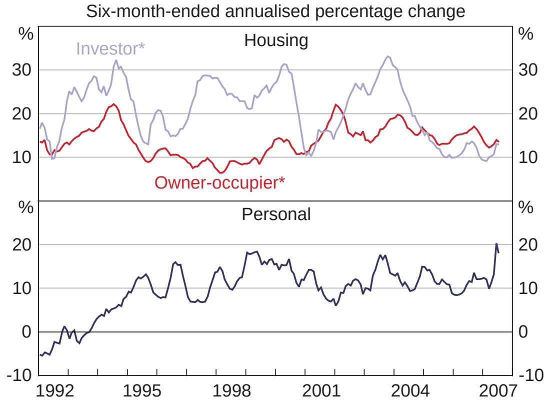
	Annual average, two years to June quarter 2006	Year to June quarter 2007
Sydney	-1.8	3.0
Melbourne	5.2	11.5
Brisbane	3.4	15.7
Adelaide	5.4	11.7
Perth	27.2	15.3
Canberra	3.3	9.0
Hobart	7.5	9.7
Darwin	20.8	7.4
Australia	**4.5**	**9.2**

Source: ABS

Graph 46

Household Credit

Six-month-ended annualised percentage change

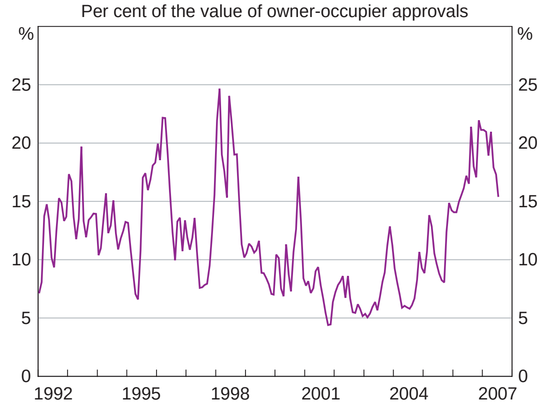


* Growth rates are estimated from bank data prior to April 2003 and data from all financial intermediaries thereafter; includes securitised loans.
Source: RBA

Graph 47

Fixed-rate Housing Loans

Per cent of the value of owner-occupier approvals



Source: ABS

three years, some lenders have reported increased demand for longer terms, including up to 10 years.

Growth in personal credit had been fairly steady for much of the past year before picking up sharply around the middle of the year. Part of the recent pick-up is likely to have reflected borrowing to fund superannuation contributions ahead of the rule changes that took effect on 1 July. Over the year to July, personal credit increased by 15 per cent, up from growth of 10 per cent in the previous year.

Within personal credit, growth in margin lending for the purchase of shares and managed funds has been especially strong, at 46 per cent over the year to June, up from 39 per cent in the previous year. Strong demand for margin loans was associated with strength in the equity market throughout much of the period, which also contributed to a relatively low frequency of margin calls. Typically, margin loans are well collateralised by the underlying securities, with an average loan-to-valuation ratio of just over 40 per cent. Partial data for the September quarter show a marked rise in the number of margin calls as a result of the increase in share market volatility.

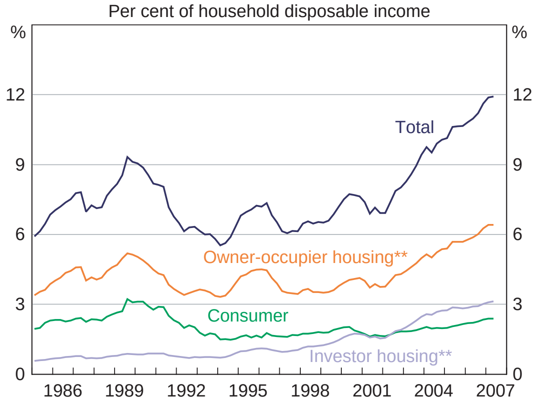
Credit cards are one component of personal credit for which growth has moderated in the past year. Outstanding credit card balances grew by 11 per cent over the year to July, down from average annual growth of around 13 per cent in the previous two years. This reflects a combination of slower growth in the number of accounts and a tendency for cardholders to repay their balances more quickly than in the past.

Continued growth in the ratio of household debt to income over recent years, together with higher interest rates, has seen the ratio of aggregate household interest payments to disposable income continue to increase. In the June quarter 2007, interest payments on household debt were equivalent to 12 per cent of household disposable income, up by around one percentage point from a year ago, and well above the previous peak (Graph 48). The bulk of the rise in this ratio over the past decade has been due to an increase in interest payments on housing loans, with the aggregate interest-payments ratio for owner-occupier loans increasing from 3½ per cent to 6½ per cent, and that on investor loans increasing from 1 per cent to 3 per cent. With the average interest rate on outstanding housing loans roughly the same in the June quarter 2007 as it was in mid 1997, the increase in the overall housing interest-payments ratio over the decade is mostly attributable to the increase in the ratio of housing debt to income – from 62 per cent to 138 per cent.

Graph 48

Household Interest Payments*

Per cent of household disposable income



* Includes the imputed financial intermediation service charge; income is after tax and before the deduction of interest payments

** Based on shares of housing credit

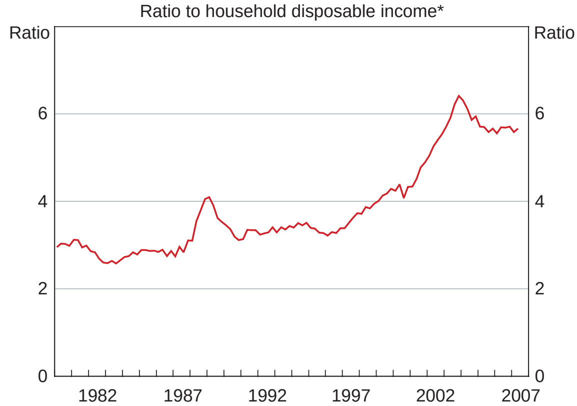
Sources: ABS; RBA

As noted in previous *Reviews*, there are three main factors that underlie this increase in the ratio of housing debt to income. First, there has been a substantial increase in the ratio of house prices to income, with the median dwelling price rising from the equivalent of 3.5 times annual household disposable income in mid 1997, to 5.7 times currently (Graph 49). This increase means that, for a given loan-to-valuation ratio, borrowers have had to take on a larger amount of debt relative to their income to purchase a median-priced house. Second, there has been an increase in the proportion of households with owner-occupier mortgage debt. According to the latest Census, 35½ per cent of households were paying off an owner-occupier loan in 2006, up from 27½ per cent in 1996, with the increase in the indebted ownership rate most evident for households in the older age groups (Graph 50). Third, there has been an increase in investor activity in the housing market, with data from the Australian Taxation Office showing a rise in the share of taxpayers with investor housing debt, from about 8 per cent in the mid 1990s to 10½ per cent in 2004/05 (the latest available data).

Graph 49

House Prices

Ratio to household disposable income*



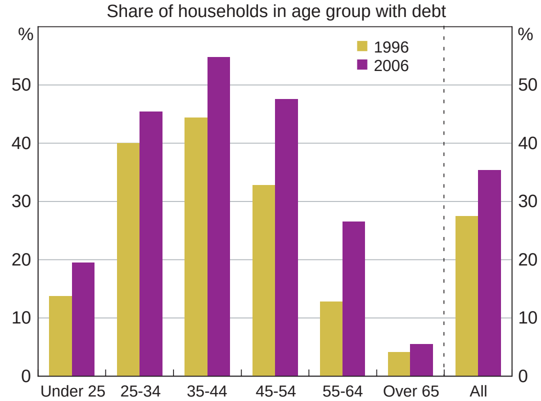
* Income is after tax and before the deduction of interest payments; excludes income of unincorporated enterprises

Sources: ABS; RBA; REIA

Graph 50

Indebted Owner-occupiers

Share of households in age group with debt



Source: ABS

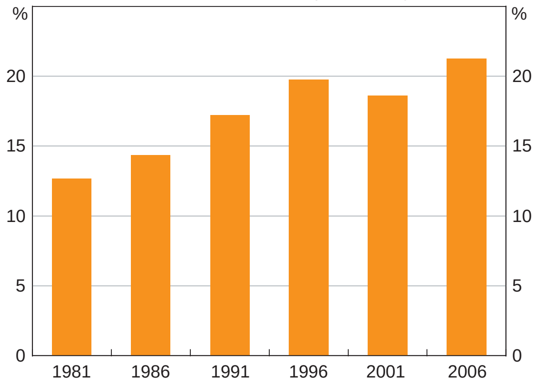
The increase in the share of households with debt means that the rise in the aggregate debt-servicing ratio overstates the rise in the average ratio for households with debt. According to estimates based on Census data, the median owner-occupier debt-servicing ratio of indebted households (calculated as interest and principal repayments – including any excess repayments – on owner-occupier debt as a share of gross household income) increased from 20 per cent in 1996 to 21½ per cent in 2006, which is less than the increase in the aggregate owner-occupier interest-payments ratio over the same period (Graph 51).

This rise in debt-servicing ratios over the past decade is not surprising given the favourable macroeconomic environment, including the strength in the labour market, over this period. In particular, the reduction in the unemployment rate to the lowest level in about 30 years, the associated growth in real incomes and the moderation in macroeconomic volatility since the 1980s has given households the confidence to take on larger debt-servicing commitments

Graph 51

Median Owner-occupier Debt-servicing Ratios*

Households with owner-occupier housing debt



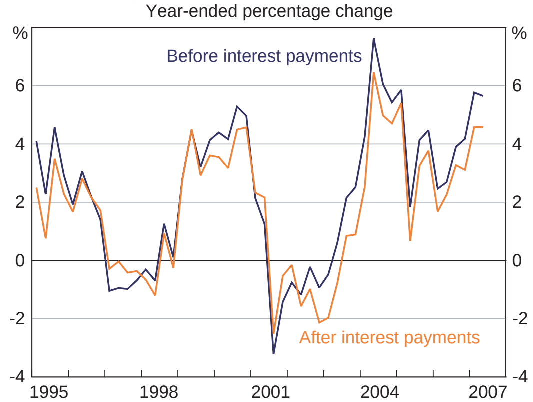
* Owner-occupier interest and principal repayments (including any excess principal repayments) as a per cent of gross household income

Sources: ABS; RBA

Graph 52

Real Disposable Income Per Household*

Year-ended percentage change



* Excludes unincorporated enterprises

Sources: ABS; RBA

relative to their incomes. Even allowing for the increase in interest payments, real disposable income averaged across all households has grown at an average annual rate of 2 per cent over the past decade, which means the average household now has a higher absolute amount of income remaining after allowing for both inflation and interest payments than was the case a decade ago (Graph 52). Consistent with this, estimates from Census data indicate that the median gross income of indebted owner-occupier households after debt payments increased by 19 per cent in real terms between 1996 and 2006. Moreover, the rate of growth was more pronounced for households in the bottom two income quintiles than for those in the top three quintiles, in part reflecting the reduction in the unemployment rate over this period.

The willingness of households to take on larger debt-servicing commitments is also reflected in an increasing share of households with debt-servicing ratios that have historically been considered high. At the time of the 2006 Census, 29 per cent of *indebted* owner-occupier households are estimated to have had debt-servicing ratios above 30 per cent, compared with 23 per cent a decade earlier. Most of this increase is accounted for by higher-income households, which accords with survey data showing that the bulk of the increase in housing debt over this period has been taken on by higher-income households, who should have the greatest capacity to repay it. There has also been a slight increase (from 62 per cent to 64 per cent) in the share of *indebted* households in the bottom two income quintiles with owner-occupier debt-servicing ratios over 30 per cent – a commonly used measure of 'housing stress'. However, as relatively few households in the bottom two quintiles have housing debt, only about 3 per cent of all households in Australia were in this situation in 2006.

Notwithstanding the increase in average debt-servicing ratios, only a small share of households are experiencing difficulties meeting their debt repayment obligations, although this share has increased over recent years. As at end June 2007, the ratio of the value of non-performing housing loans to total housing loans on banks' domestic balance sheets stood at 0.41 per cent, a rise of about 0.2 of a percentage point since mid 2003, when this ratio was at extremely low levels (Graph 53). Over the past couple of years, the share of these loans that are not well covered by collateral has risen. This reflects the general increase in loan-to-valuation ratios on new loans, as well as the weakness in residential property prices in some parts of the country.

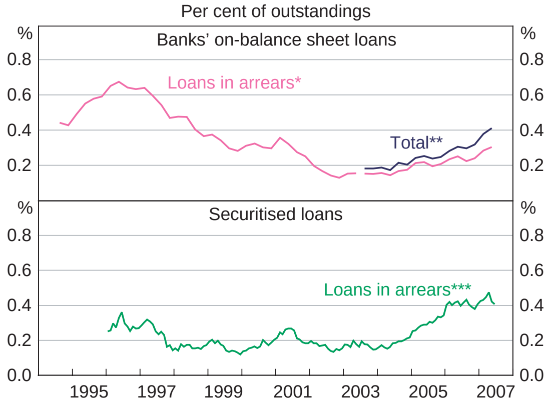
The 90-day arrears rate on securitised prime housing loans was also 0.41 per cent in June, and has been broadly unchanged since the beginning of 2006, after increasing in 2004 and 2005. This levelling out in the arrears rate is reflected in the data on the repayment record of loans by year of origination. Securitised full-doc loans made in 2005 and 2006 are currently showing a somewhat better repayment record than loans that were made in 2004 (Graph 54).

The securitisation data also show that borrowers who have taken out non-conforming loans and low-doc loans are more likely to be experiencing repayment difficulties than borrowers with standard loans (Graph 55). Non-conforming loans are the closest equivalent to sub-prime loans in the United States and represent only about 1 per cent of housing loans in Australia, compared with the 15 per cent sub-prime share in the United States. While the 90-day arrears rate on securitised non-conforming loans has risen consistently over the past couple of years – and is currently around 7 per cent – it is still considerably lower than the equivalent arrears rate on sub-prime loans in the United States. For low-doc loans – which account for around 7 per cent of housing loans outstanding in Australia – the arrears rate is much lower than that on non-conforming loans, at 0.95 per cent, and has increased only slightly over the past year.

Graph 53

Non-performing Housing Loans

Per cent of outstandings

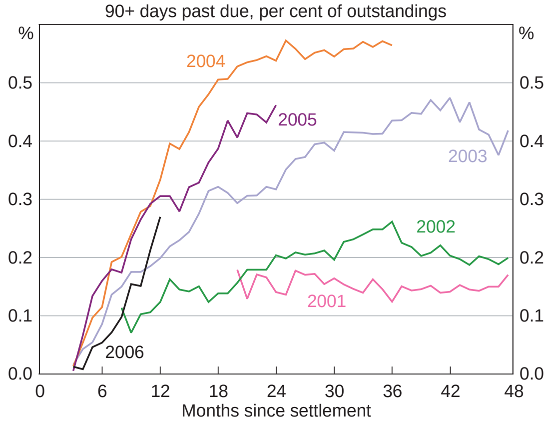


* Loans that are 90+ days past due but otherwise well secured by collateral
** Includes 'impaired' loans that are in arrears and not well secured by collateral
*** Prime loans securitised by all lenders, 90+ days past due
Sources: APRA; Standard & Poor's

Graph 54

Housing Loan Arrears by Cohort*

90+ days past due, per cent of outstandings

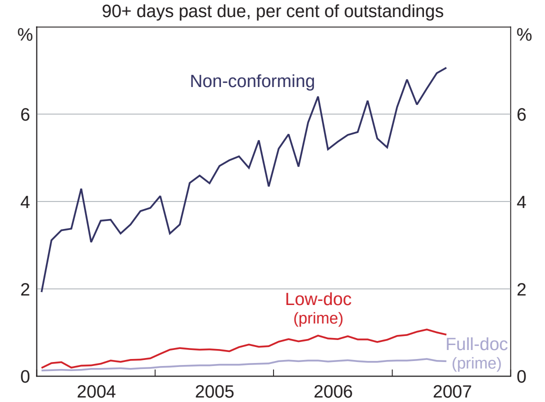


* Prime securitised full-doc loans
Source: RBA

Graph 55

Housing Loan Arrears*

90+ days past due, per cent of outstandings

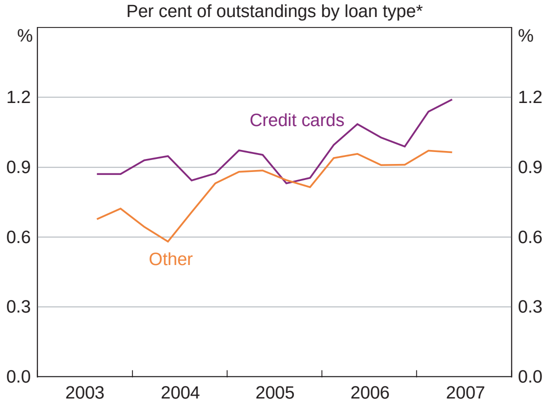


* Securitised loans
Sources: RBA; Standard & Poor's

Graph 56

Banks' Non-performing Personal Loans

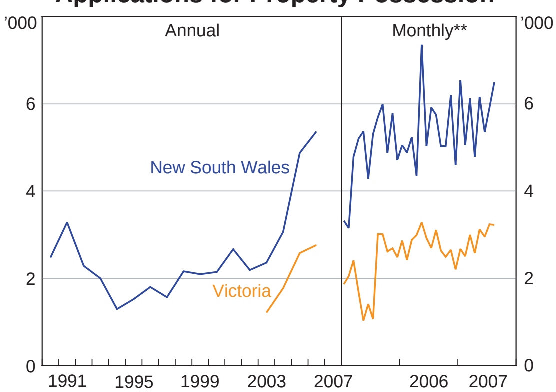
Per cent of outstandings by loan type*



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

Graph 57

Applications for Property Possession*



* Includes applications for possession of some commercial, as well as residential, properties
** Annualised
Sources: Supreme Courts of NSW and Victoria

Despite the increase in non-performing housing loans over the past few years, the arrears rate remains low by international standards. Moreover, the recent increase is not unexpected, particularly given the strong competition in lending markets over the past decade or so, which has made housing finance available to a broader range of borrowers. The general easing of credit standards over this period has meant that the marginal borrower over recent years has been riskier than was the case a decade ago and, as a consequence, the arrears rate for a given level of interest rates and unemployment is likely to be higher than was the case in the past.

A modest increase in arrears rates over recent years is also apparent for banks' personal loans and on credit card debt. As at June 2007, the non-performing rate for credit cards was 1.2 per cent, up from 1.1 per cent a year earlier (Graph 56). For banks' personal loans, the equivalent figure was a little under 1 per cent in June 2007 and broadly unchanged over the year. As with housing loans, both of these rates remain low by international standards. In addition, the rate of growth of credit card cash advances, another possible indicator of financial distress, has slowed markedly over the past year.

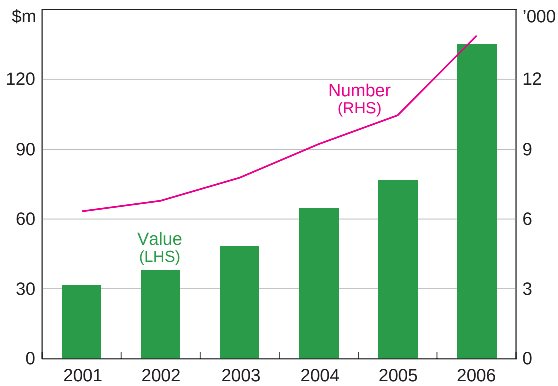
The number of court applications for property repossession has also risen over recent years, although less so in 2007 (Graph 57). Over the year to August, there were 5 605 such applications in New South Wales and 2 775 in Victoria, although these figures overstate the number of housing repossessions that eventually occur, as borrowers can choose to sell their property or refinance the loan before the lender goes through all the remaining legal steps to take possession (see Box B). Liaison suggests that some of the newer, non-bank, entrants to the housing loan market are quicker than traditional lenders to seek repossession.

Another measure of the financial condition of the household sector is the number of applications to the Australian Prudential Regulation Authority (APRA) for early release of superannuation benefits in order to overcome financial stress, either resulting from mortgage payments or medical expenses. In 2006, 13 871 such applications were approved for a total release of $135 million of superannuation benefits, compared with 10 459 approvals for the release of $77 million in the previous year (Graph 58). Part of this increase is likely to reflect a change in behaviour, with some lenders promoting access to superannuation as one way for borrowers in difficulty to get up to date on their mortgage obligations.

While the various indicators show some increase in the share of households experiencing financial difficulties over recent years, the vast bulk of borrowers are still meeting their debt repayment obligations. Moreover, many borrowers are making excess principal repayments on their housing loans. Liaison with banks indicates that about one quarter of owner-occupier borrowers are more than a year ahead on their mortgage repayments, and around one half are ahead by more than a month. Data on a sample of securitised housing loans suggest that the rate of net excess principal repayments (i.e. net of redraws of excess principal previously paid) averaged around 0.3 per cent of outstanding loan balances per month during 2006 – equivalent to 3½ per cent at an annual rate (Graph 59).[1] While this is a lower rate than earlier in the decade, it has picked up a little since late 2005 reflecting, in part, a desire by some borrowers to repay their loans more quickly given robust real income growth and

Graph 58

Approvals for Early Release of Superannuation Benefits

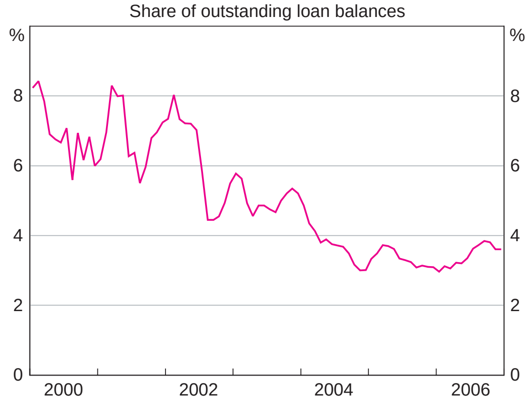


Source: APRA

Graph 59

Excess Repayments Less Redraws on Housing Loans*

Share of outstanding loan balances



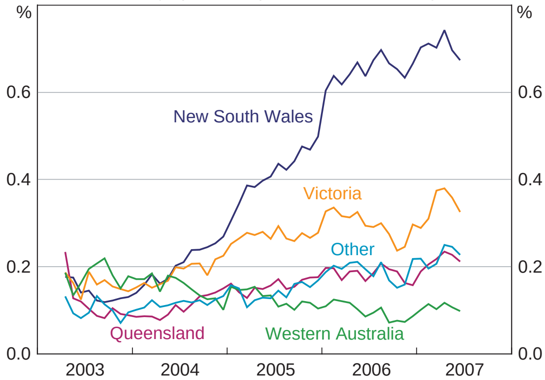
* Three-month moving average, annualised; seasonally adjusted
Source: RBA

1 *See Reserve Bank of Australia (2007), 'Loan Approvals, Repayments and Housing Credit Growth',* Bulletin, *July.*

Graph 60

Housing Loan Arrears by State*

90+ days past due, per cent of outstandings

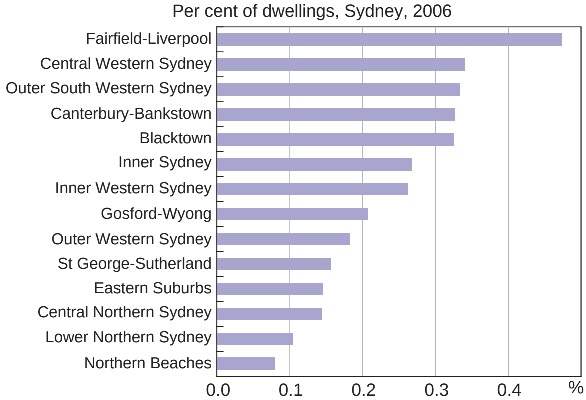


* Prime securitised loans
Source: RBA

Graph 61

Writs of Possession by Region

Per cent of dwellings, Sydney, 2006

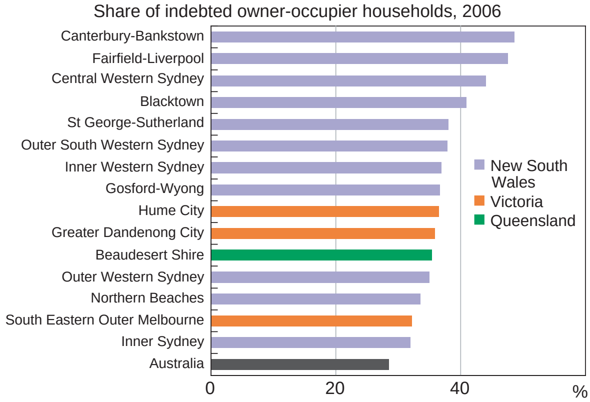


Sources: ABS; Office of the Sheriff of NSW

Graph 62

Households with Owner-occupier Debt-servicing Ratios Over 30 Per Cent

Share of indebted owner-occupier households, 2006



Sources: ABS; RBA

increases in interest rates. Surveys of consumer sentiment also suggest that households remain reasonably positive about their personal finances.

Even though the picture is reasonably benign at the aggregate level, disaggregated data do show there are some pockets of difficulty. These are most noticeable in New South Wales, where the mortgage arrears rate has been higher than in the other states for some time (Graph 60). Within New South Wales, higher arrears rates appear to be concentrated in western Sydney. This is consistent with other indicators which suggest that this area is experiencing more financial difficulties than many other areas. Court data suggest that the number of writs of possession have been highest in western Sydney, and Census data show that the share of households in this part of Sydney with a (owner-occupier) debt-servicing ratio above 30 per cent is considerably higher than in other parts of the country (Graphs 61 and 62). The unemployment rate in western Sydney has also risen slightly and property prices have been under downward pressure. In addition, a disproportionately large number of borrowers in this part of Sydney took out investment housing loans around the peak of the house price cycle.

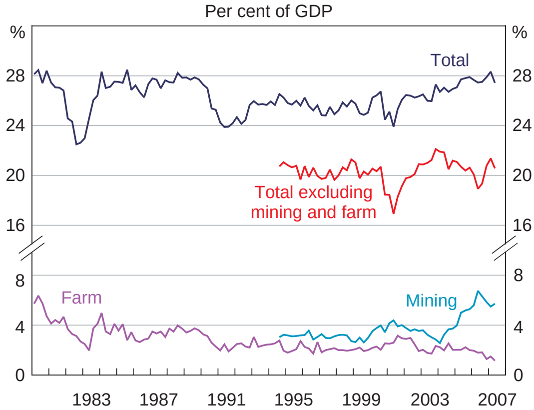
Over the past couple of years, there has also been a disproportionately large increase in the number of personal administrations (mainly personal debt agreements and bankruptcies) in New South Wales compared with the other States. At the national level, it is also notable that there has been an increase in the proportion of people nominating 'excessive use of credit' as the primary cause of their bankruptcy – about one quarter nominated this in 2005/06, up from 10 per cent in the late 1990s – but this share is still well below that in the late 1980s when excessive use of credit was nominated as the primary cause of about one half of all personal bankruptcies.

Business Sector

The strong expansion of the Australian and global economies has continued to underpin favourable conditions in the business sector. In aggregate, business finances are in good shape, with profit growth continuing at a strong pace and debt-servicing ratios remaining at low levels. Notwithstanding the ready availability of internal funding, strong growth in investment over recent years has been associated with an increase in external fund raising, mainly intermediated debt, which has recently been growing at its fastest pace since the late 1980s. This has resulted in an increase in overall gearing, although business balance sheets remain in sound condition, with business loan arrears rates at low levels. While six months ago it looked as if the period of conservative gearing in the business sector might be coming to an end – with the boom in leveraged buyouts being the clearest sign of this – the recent turbulence in global credit markets makes it less clear how this will play out in the period ahead.

Profits of the non-financial business sector – as measured by the gross operating surplus of private non-financial corporations and gross mixed income of unincorporated enterprises – increased by 8 per cent over the year to the June quarter 2007, broadly in line with average growth over the past decade. (These figures are adjusted for the reclassification of Telstra from the public to the private sector in the March quarter 2007.) Profits have increased as a share of GDP since earlier in the decade, with this ratio currently around historically high levels (Graph 63).

Graph 63
Business Profits*
Per cent of GDP

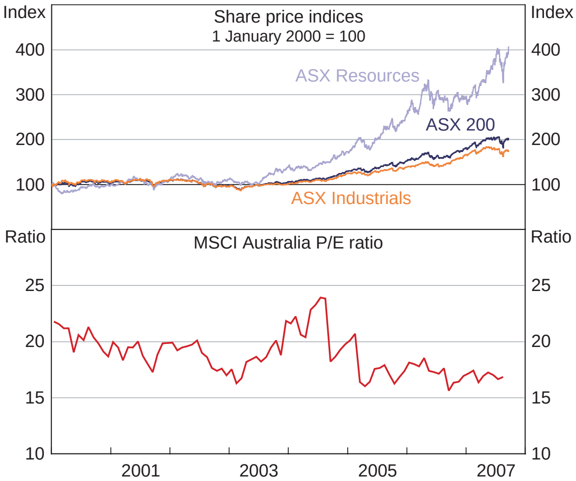


* Private non-financial corporations and unincorporated enterprises; adjusted for privatisations
Sources: ABS; RBA

There has been a marked change in the composition of aggregate profit growth over the past year, with profit growth of the mining sector slowing, offset by a pick-up in profit growth of the non-mining sector. The notable exception to this is the farm sector, where profits have weakened considerably owing to drought conditions. For the business sector as a whole, the profit outlook is positive, with surveys indicating that firms' expectations of profitability are at, or above, long-run average levels and equity analysts continuing to forecast fairly solid earnings growth for listed non-financial companies over the next few years.

Graph 64

Share Price Indices and P/E Ratio

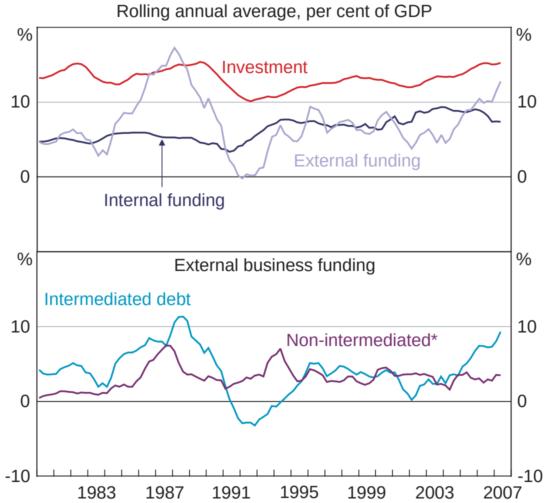


Sources: Bloomberg; MSCI; Thomson Financial

Graph 65

Business Funding and Investment

Rolling annual average, per cent of GDP



* Includes non-intermediated debt, hybrids and equity raisings net of buybacks

Sources: ABS; ASX; Austraclear; RBA

Strong corporate profitability in recent years has been reflected in share price gains through much of the period. Notwithstanding the recent falls, the ASX 200 is 26 per cent higher than a year ago, and has roughly doubled since mid 2003 (Graph 64). This is above the increases seen in major overseas share markets over the same period. In aggregate, the share price increases of the past few years have been well supported by earnings growth, so there has been relatively little change in the price/earnings (P/E) ratio. Currently, the P/E ratio for Australian companies stands at about 17, around the average of the past two decades.

As noted in the most recent *Statement on Monetary Policy*, the favourable macroeconomic environment has been associated with a strong rise in business investment, from 12½ per cent of GDP in mid 2002 to 16 per cent in the June quarter of 2007 (Graph 65). While strong profit growth has enabled businesses to finance part of this expenditure out of internally generated funds, external fund raising has also picked up significantly over the past few years. Over the year to June 2007, external funding represented 63 per cent of new business finance and was equivalent to about 13 per cent of GDP, up from 5½ per cent in 2003. Total business funding in the past couple of years has exceeded firms' fixed investment spending, with the excess being used to accumulate financial assets, mainly deposits and offshore equity.

The bulk of the increase in external funding in recent years has been in the form of intermediated credit, which has recently been growing at annual rates of around 19 per cent, the fastest pace since the late 1980s (Graph 66). APRA data also indicate that the strong growth in business credit is being driven by larger businesses, with the outstanding value of bank loans

Table 8: Banks' Business Lending

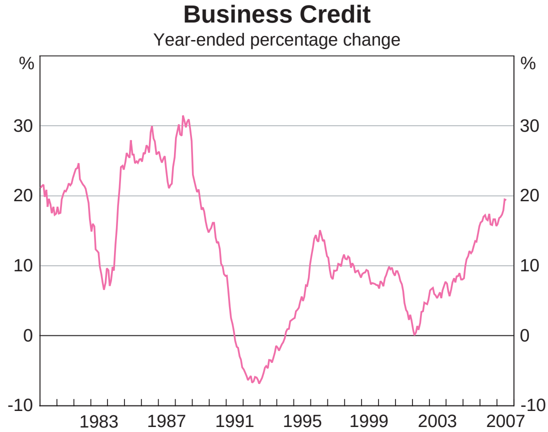
June 2007, by loan size

Loan size	Level	Share of total	Year-ended growth
	$b	Per cent	Per cent
Less than $500 000	93.8	17.4	-0.5
$500 000 to $2 million	93.4	17.3	22.1
Greater than $2 million	352.1	65.3	31.0

Source: APRA

greater than $2 million rising by 31 per cent over the year to June 2007 (Table 8). This is partly due to the strong growth in syndicated lending, for which approvals have been at record levels in recent years. In the year to June 2007, $124 billion of syndicated loans were approved, up from $84 billion in the previous year.

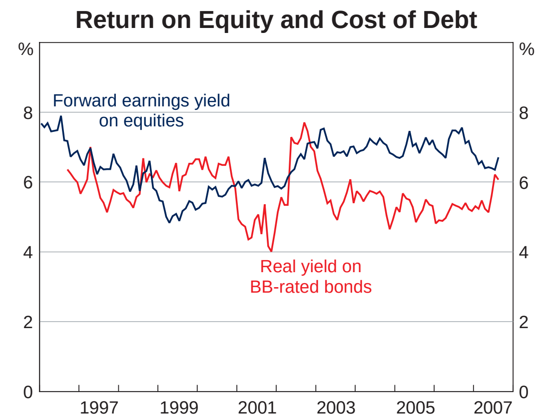
Graph 66



Source: RBA

The recent strength in syndicated lending partly reflected the boom in leveraged buyout (LBO) activity that was particularly prominent in 2006 but has moderated in 2007. In the six months to June, the total value of LBO deals completed was around $2 billion, down from $9 billion in the second half of 2006, with a number of major proposed buyouts not proceeding. While there are a variety of reasons for these deals not going ahead, a less receptive funding environment is one factor that is likely to limit LBO activity in the period ahead. The recent volatility in global credit markets has closed the gap between the cost of debt and the return on equity that was one of the main drivers of LBO activity in 2006 (Graph 67). Investors still prepared to fund LBOs are now demanding more covenant protection, effectively ending the trend toward so-called covenant-lite loans. Even though LBO activity has fallen, there is still a large value of other merger and acquisition deals in the pipeline (Graph 68).

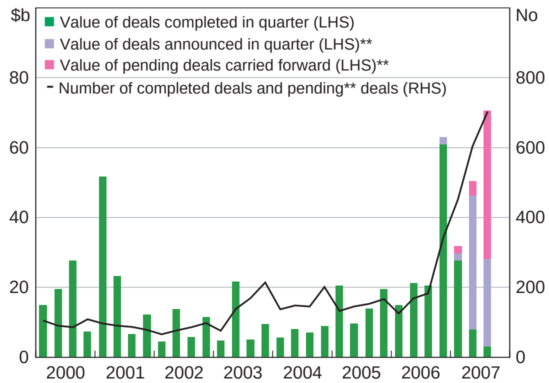
Graph 67



Sources: Merrill Lynch; RBA; Thomson Financial; UBS AG, Australia Branch

Graph 68

Mergers and Acquisitions by Listed Australian Entities*

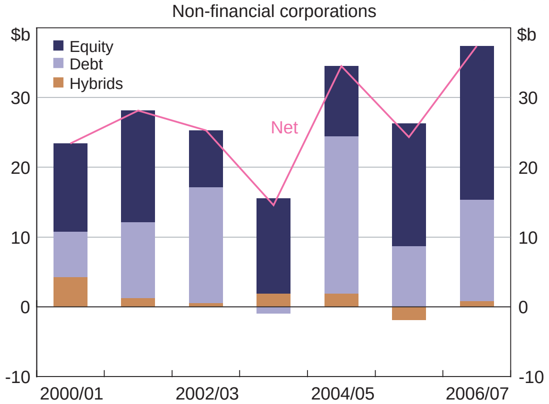


* Excludes real estate transactions
** Transactions announced since October 2006 but not completed
Sources: RBA; Thomson Financial

Graph 69

Net Non-intermediated Capital Raisings

Non-financial corporations



Sources: APRA; ASX; Austraclear; RBA

Unlike intermediated debt, net non-intermediated capital raisings by non-financial companies have been broadly steady as a share of GDP over recent years. Within the total, annual net equity raisings rose from $10 billion in 2004/05 to $22 billion in 2006/07, while net debt issuance in 2006/07 was $8 billion lower than the peak of $22½ billion reached in 2004/05, mainly owing to reduced offshore bond issuance (Graph 69). Looking over a longer period, non-intermediated debt has become a more important source of funding for private non-financial corporations, comprising 19 per cent of their outstanding debt in March 2007 compared with around 11 per cent in the mid 1990s (Graph 70). There has also been a greater tendency for these companies to issue longer-term debt securities and to issue more of these securities within Australia rather than offshore.

In terms of overall balance sheets, business leverage has tended to increase over recent years. For listed non-financial corporations, the debt-to-equity ratio has risen by 12½ percentage points since December 2004, to stand at 68 per cent (Graph 71). This is close to its post-1980 average, but well below the level in the late 1980s, when it exceeded 100 per cent. Underlying this increase have been some divergent trends at the sectoral level. The very strong profitability of resource companies has allowed these companies to finance their investment out of earnings without increasing their debt levels, while the gearing of companies outside the resources sector has tended to rise, albeit for a relatively small number of companies and from quite low levels in most cases.[2] For all non-financial businesses, the ratio of debt to profits has risen over recent years, but interest-servicing requirements remain at a relatively low level owing to the strength of profitability and the compression in lending margins (Graph 72).

2 *See Reserve Bank of Australia (2007), 'Box D: Recent Developments in Corporate Gearing in Australia',* Statement on Monetary Policy, *August.*

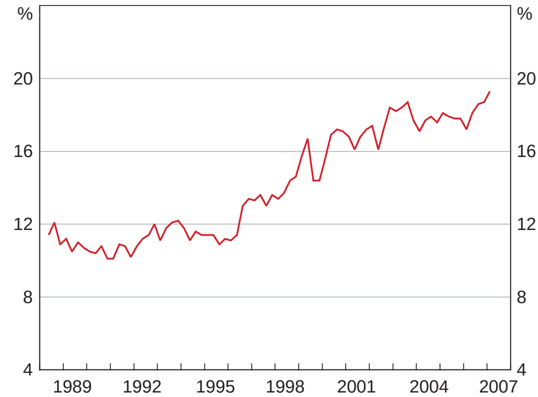
In line with low debt-servicing requirements, arrears rates on banks' business loans are lower than a few years ago (see *The Australian Financial System* chapter). In addition, there has been no default on a (rated) corporate bond since 2004. One area where there has been a number of recent high-profile corporate failures is residential property development. In part, this reflects soft conditions in the residential property market in recent years, but also appears to be due to a number of company-specific factors, including high borrowing costs and overheads, and high-risk business models. The chapter on *Developments in the Financial System Infrastructure* contains a discussion of some of the regulatory issues associated with these collapses.

The positive business environment continues to be reflected in most business surveys, financial market pricing and credit ratings. According to a range of business surveys, actual and expected business conditions have strengthened recently and are well above long-run average levels. Non-financial corporate bond spreads and credit default swap (CDS) premia remain lower than earlier in the decade, though they have widened in the past few months, in line with developments in corporate debt markets internationally (Graph 73). The recent increases in CDS premia have occurred across the corporate sector, in contrast to the increases earlier in the year,

Graph 70

Non-intermediated Debt

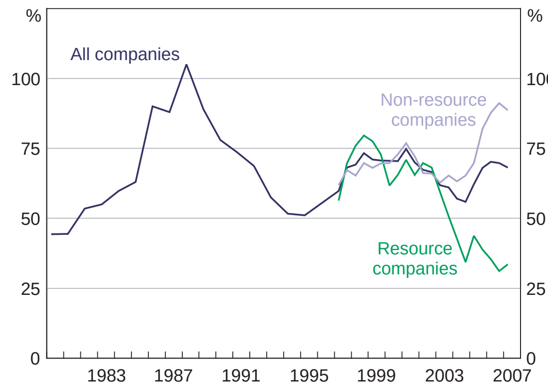
Per cent of total private non-financial corporate debt



Source: ABS

Graph 71

Listed Non-financial Companies' Gearing Ratio*

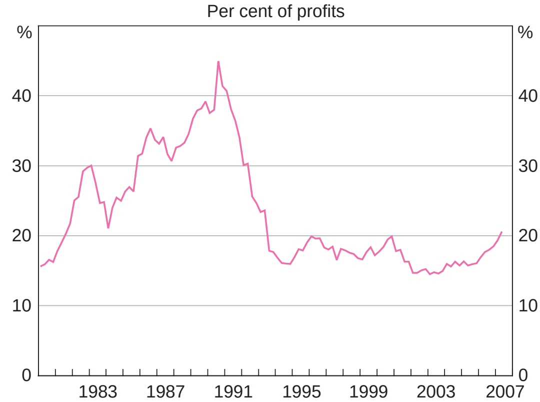


* Gross debt/shareholders' equity; book value; excluding foreign companies
Sources: Aspect Huntley; RBA; Statex

Graph 72

Business Interest Payments*

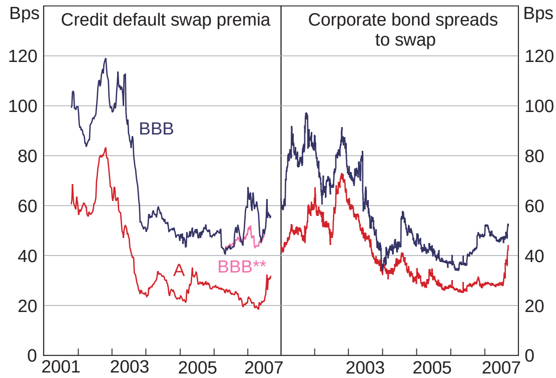
Per cent of profits



* Includes the imputed financial intermediation service charge
Sources: ABS; RBA

Graph 73

Corporate Credit Risk*



* Non-financial corporate bonds with 1-5 years maturity and 5-year credit default swaps
** Excluding takeover targets
Sources: AFMA; Bloomberg; RBA; UBS AG, Australia Branch

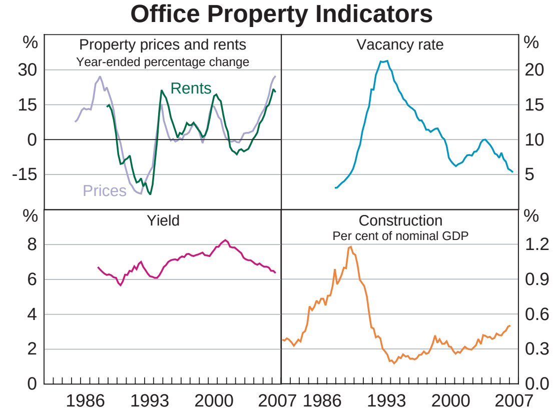
Table 9: Banks' Australian Commercial Property Exposures
March 2007, per cent

	Share of banks' total business credit	Year-ended growth
Office	7	27
Retail	4	8
Industrial	3	31
Residential	7	8
Tourism and leisure	2	54
Other	3	13
Total	**27**	**18**

Source: APRA

Graph 74

Office Property Indicators



Sources: ABS; Jones Lang LaSalle; RBA

which were largely confined to a subset of companies that were takeover targets in leveraged buyout deals. As has been the case in recent years, ratings actions of credit rating agencies are consistent with positive business conditions, with Standard & Poor's making more rating upgrades than downgrades for Australian companies in the past year.

One particular area of interest is the commercial property market, given the role that this market has played in financial stresses in the past. Commercial property lending, which accounts for about one quarter of banks' business credit and about 10 per cent of their total credit, has been growing rapidly over the past few years. Lending for offices – which accounts for around one quarter of banks' total commercial property lending – increased by 27 per cent over the year to March 2007, and lending for industrial property grew by 31 per cent (Table 9). Competitive pressures in this segment of the business lending market have strengthened in recent years, with downward pressure on margins on commercial property loans and pressure to ease other terms and conditions on such loans. Nonetheless, as discussed in *The Australian Financial System* chapter, the share of banks' commercial property exposures that is impaired is very low and has declined in recent years. This reflects buoyant conditions, particularly in the office property market, where prices and rents are growing strongly and vacancy rates are low (Graph 74). In part, this is the result of some supply shortages, with office construction as a share of GDP being well below the levels of the late 1980s, although the tightening in office property markets has prompted a noticeable pick-up in planned construction.

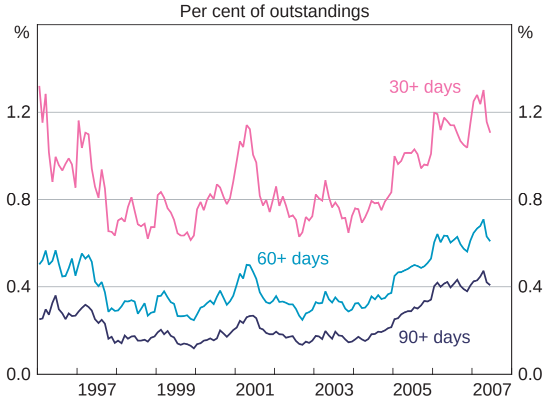
Box B: Arrears and Repossessions

The share of housing loans that is in arrears has increased over recent years but remains at relatively low levels. Most households that fall behind in their mortgage payments eventually make up the overdue payments and return to their original repayment schedule, that is, they 'self cure'. Consistent with this, the proportion of securitised housing loans in arrears by 90 days or more is always considerably lower than the share that is at least 30 days in arrears. As at June 2007, 1.11 per cent of (securitised) loans were more than 30 days past due, compared with 0.41 per cent that were more than 90 days in arrears (Graph B1). The difference in the duration of arrears is more pronounced for low-doc loans, reflecting the fact that these borrowers are more likely to have 'lumpy' income flows.

Graph B1

Housing Loan Arrears*

Per cent of outstandings



* Prime loans securitised by all lenders
Source: Standard & Poor's

For some borrowers who cannot rectify their repayment difficulties, one possibility is to refinance their loan, often with a non-conforming lender. In many cases, however, this is unlikely to be a longer-term solution, given the higher interest rates involved and the transaction costs associated with refinancing.

An alternative is for the borrower to voluntarily sell the property. While this is usually a difficult decision, liaison suggests that voluntary sales often achieve a 15 to 20 per cent higher price than mortgagee-in-possession sales.

Another alternative is for the borrower to access some of their superannuation in order to get loan repayments back on schedule. Borrowers can do this either by applying to the Australian Prudential Regulation Authority for the early release of some of their superannuation benefits on 'compassionate grounds' or, if they are in receipt of a Commonwealth income support payment, by applying directly to the trustees of their superannuation fund on the grounds of severe financial hardship. To some extent, the increased use of these options over recent years reflects a growing awareness by borrowers of their availability.

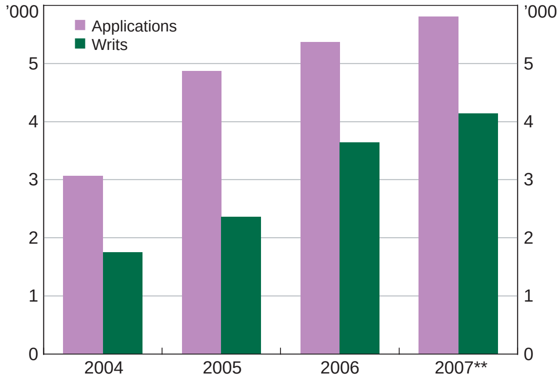
Given these avenues of resolution, only a small percentage of borrowers who fall into arrears have their property repossessed by the lender. There are a number of steps involved in this legal process, with its exact nature depending on the jurisdiction, as well as other factors, such as the method of filing the claim. In New South Wales, for example, there are three broad steps. First, the lender must submit an application to the Supreme Court of NSW after the borrower has failed to service the loan, generally for a number of months. A judgement in the lender's favour does not, however, entitle the lender to evict the borrower. Instead, the lender must also obtain a 'writ of possession' from the Supreme Court, although it is possible for this second step to be undertaken at the same time as the first step. Third, the writ must then be executed on the borrower. The avenues discussed earlier are no longer available once a writ has been executed. Liaison suggests that the entire repossession process often takes up to a year.

Comprehensive data on the number of applications and writs are not available for all states, and there are limited data available on the number of writs that are actually executed. The Supreme Court of NSW and the Office of the Sheriff of NSW have, however, provided NSW data to the Bank. These data show that there were 5 368 applications for repossession to the Court in 2006, equivalent to 0.23 per cent of the number of private dwellings in the State (Graph B2).[1] Over the same period, the Court granted 3 642 writs of possession. The ratio of writs to applications – at around two thirds – was higher than in the previous two years and was higher again for the first eight months of 2007 (although a small part of this rise reflects recent changes in procedural practices between the Supreme Court and the Office of the Sheriff of NSW).

Graph B2

Applications and Writs of Possession*

New South Wales



* Applications and writs of possession include some commercial, as well as residential, properties

** Eight months to August annualised

Sources: Office of the Sheriff of NSW; Supreme Court of NSW

A comparison of applications for repossession in NSW, relative to the State's number of dwellings, and arrears rates since the early to mid 1990s reveals that, over this period, there has been an increase in the number of repossessions for a given number of loans in arrears. Over the same period, there has been a significant increase in the relative importance of 'non traditional' lenders, and liaison suggests that these lenders act relatively quickly to obtain and execute repossession judgments.

1 *This compares with an arrears rate of 0.69 per cent for (securitised) housing loans made to borrowers in NSW. This does not imply that one third – 0.23 versus 0.69 – of borrowers in arrears are subject to an application for repossession; liaison suggests that the average amount of time spent in arrears is less than four months, whereas the repossession rate of 0.23 per cent refers to all repossessions in the entire year.*

Developments in the Financial System Infrastructure

Basel II

The Australian Prudential Regulation Authority's (APRA) revised prudential standards for authorised deposit-taking institutions (ADIs) based on Basel II are scheduled to come into effect on 1 January 2008. Most ADIs will use the standardised approaches, with only a small number of large banks having applied to become accredited by APRA to use the more advanced approaches. Announcements regarding which banks will receive accreditation for these advanced approaches from 1 January are expected in the near future.

The implementation of Basel II is expected to lead to a modest decline in the minimum amount of capital that ADIs are required to hold. This mainly reflects the reductions in regulatory capital requirements on most housing loans. Offsetting these reductions are the introduction of capital requirements for operational risk, and APRA's decision to use national discretion to introduce an explicit capital charge for interest-rate risk in the banking book for those ADIs using the advanced approaches. Further, in recognition that past experience in the housing loan market in Australia may not be a very good guide to future losses, APRA has set a minimum transitional 'loss given default' of 20 per cent for those banks using the advanced approaches for credit risk. It has also indicated that in 2008 any reduction in minimum regulatory capital for ADIs accredited to use the advanced approaches will be limited to 10 per cent of the capital that would have been required had current arrangements continued. This limit will be retained in 2009 pending a review based on experience.

While minimum capital requirements for the system as a whole are likely to decline a little, the combination of APRA's new capital requirements and changes to accounting standards is likely to lead to an improvement in the overall quality of capital, as some ADIs will need to hold a higher proportion of their total regulatory capital in the form of non-innovative Tier 1 capital.

As part of the implementation of Basel II, APRA is proposing to build on its existing processes of supervisory review to set a prudential capital requirement (PCR) for each ADI that must be met at all times. The PCR will be set at a level that is appropriate to each ADI's overall risk profile, with the minimum PCR being 8 per cent of risk-weighted assets.

The implementation of Basel II will also see further improvements in the already high level of disclosure by ADIs. All ADIs will be required to disclose a basic set of information on their capital adequacy, broadly similar to current reporting requirements, but with some additions in areas such as operational risk and securitisation. ADIs using the advanced approaches will be required to make extensive additional disclosures of quantitative and qualitative information (reported semi-annually and annually respectively). APRA may also vary the disclosure requirements for an ADI depending on its particular circumstances.

The implementation of Basel II has been a lengthy process. It has, however, provided strong incentives for ADIs to upgrade and improve their risk management systems, business models, capital strategies and disclosure frameworks.

The Regulatory Response to Property Company Collapses

Over the past 18 months, four property development companies in Australia have gone into receivership – Westpoint, Fincorp, Australian Capital Reserve and Bridgecorp. In total, around 20 000 investors in these companies are owed approximately $900 million. All four companies were mainly involved in residential property development.

The administrators of the failed companies are examining the options available to minimise the losses to investors. Options include selling existing assets and completing property developments that are already underway. Several Fincorp properties are in the process of being sold, and secured noteholders have been notified that they are likely to receive a return of around 50 cents in the dollar (unsecured noteholders are not expected to receive any return). Administrators for Australian Capital Reserve have estimated that investors will receive at least 60 cents in the dollar, while the administrators of Bridgecorp are yet to release information about likely returns. For Westpoint, returns to investors will vary across the different development projects, and in some cases are still unknown.

The Australian Securities and Investments Commission (ASIC) is investigating the failed companies and their directors for any wrongdoing and has proposed changes to market disclosure requirements. It has sought, and obtained, orders to freeze assets of the former directors of Fincorp and, in some cases, those of their spouses, pending further investigations into the disposal of assets. For Westpoint, ASIC is continuing to investigate possible criminal behaviour, with charges against some individuals already being laid. Westpoint's use of promissory notes with a face value of over $50 000 was an attempt to avoid certain provisions of the *Corporations Act 2001* intended to provide some safeguards to retail investors. However, in 2006 the Supreme Court of Western Australia ruled that because the promissory notes were used to fund a managed investment scheme, they were subject to the Corporations Act.

These recent failures have focused attention on the issue of how well investors understand the risks involved in some debentures, particularly those issued by entities that are neither rated nor listed on the stock exchange. In total, unlisted and unrated debentures account for approximately $8 billion of the $34 billion in debentures currently on issue to retail investors and self-managed super funds. ASIC has recently released a consultation paper which proposes means of improving the quality of disclosure to retail investors in these debentures. Under the proposals, ASIC would establish a series of benchmarks with issuers being required to disclose whether they meet these benchmarks, and if not, why not.

The proposed benchmarks are as follows:

1. Issuers should have their debentures rated for credit risk by a recognised agency, and have that rating disclosed in the prospectus and in advertising.
2. Issuers should have a minimum of 20 per cent equity where funds are lent, directly or indirectly, to property developers.

3. Issuers should estimate their cash needs for the next three months and have cash on-hand to meet these needs.
4. Issuers lending money for property development should be required to maintain a maximum 70 per cent loan-to-valuation ratio, based on a valuation that assumes the development is completed, and 80 per cent on the basis of the latest market valuation.
5. Issuers should disclose details of loans they have extended, or expect to extend over the coming year.
6. Valuations should be fully disclosed. Development property assets should be valued on a cost, 'as is' and 'as if complete' basis, with all three disclosed.
7. Issuers should disclose how many loans they have made to related parties, or expect to make to related parties over the next 12 months, and what assessment and approval process they follow for such loans.
8. Issuers should disclose their approach to rollovers of debentures, including automatic rollovers.

ASIC also proposes that advertising for these products should not use words such as 'secure' and 'safe', and should disclose prominently that there is a risk that investors may lose some, or all, of their capital. It is envisaged that trustees, advisers, valuers and auditors would use these benchmarks to fulfil their responsibilities. For retail investors, ASIC also plans to produce an Investment Guide to help with understanding disclosure documents, and conduct an education campaign to improve investor understanding of investment principles, such as diversification.

The Reserve Bank supports the general approach being taken by ASIC as a way of assisting investors to make more soundly based investment decisions.

Non-operating Holding Companies

A number of ADIs are considering establishing non-operating holding companies (NOHCs). The likelihood of them doing so has increased following the removal in June 2007 of a number of regulatory and tax impediments which made it unattractive for some banks to convert to a NOHC structure. Around the same time, APRA released a discussion paper on changes to the prudential standards relating to capital adequacy, some of which finalised APRA's treatment of conglomerate groups containing one or more locally incorporated ADIs.

The changes relating to conglomerate groups have their origins in the Wallis Inquiry into the Australian financial system which recommended that non-operating holding company (NOHC) structures should be permitted in Australia. The Inquiry felt that such a structure would enhance the ability of a holding company to isolate risk within a subsidiary, as it would facilitate a legal separation that quarantined the assets and liabilities of the various entities, making creditors of a failed subsidiary unable to make claims on other parts of the group. It would also bring Australia into line with other countries where this type of structure is common.

Acting on the recommendation of the Inquiry, the Government revised the *Banking Act 1959* to allow for NOHCs, and in 2002 APRA released its ADI policy framework for the operation of NOHCs. Key elements of the framework relate to capital adequacy and limits on exposures of the ADI to other parties within the NOHC. Minimum capital requirements could be applied not only to a NOHC, but also to a group headed by a NOHC. Non-financial businesses could, in principle, be part of a NOHC structure, though APRA has retained the power, under the Banking Act, to issue directions to a NOHC. APRA's policy also allowed for group 'badging', provided that it did not create the impression that a non-ADI member of the group was an ADI, or was guaranteed support by the ADI.

Currently, only two banks in Australia operate under a NOHC structure – BankWest (under HBOS Australia) and Member's Equity Bank.

Financial Compensation by Australian Financial Services Licensees

Retail clients of financial services licensees can suffer losses because of inappropriate advice, fraud or lack of disclosure by licensees, which include financial planners. Licensees are not required to have compensation arrangements in place despite the fact that retail clients can make claims for compensation directly against them. In some circumstances, licensees have not been able to meet all the claims and, as a result, retail clients have not received compensation even when they were entitled to it.

In response, new regulations have been passed by the Government requiring financial services licensees who provide services to retail clients to have in place adequate compensation arrangements, mainly via professional indemnity insurance, although certain APRA-regulated entities will be exempt from this requirement. Where professional indemnity insurance policies do not provide cover for all the situations required under the new regulation, the licensee will have to use its own financial resources to self-insure (with the approval of ASIC). Many licensees already have some form of insurance, as it has become a standard element of business best practice, along with being a condition of membership of the Financial Planning Association and the Australian Securities Exchange. The compensation requirements are not intended to cover product failure or general investment losses.

ASIC has released a consultation paper on how it proposes to implement the new regulations and ensure that the objectives of the revised compensation scheme are met. The comment period on the consultation paper closed on 14 September 2007.

Regulation of Mortgage Brokers

The regulation of mortgage brokers in Australia has been under consideration for some time. In part, this reflects concerns that a small number of brokers may have been associated with predatory lending practices and that their remuneration structures – predominantly high upfront and low trailing commissions – might have adverse consequences for both borrowers and lenders.

There is no national licensing or regulation of mortgage brokers. ASIC's licensing powers do not extend to brokers who only advise on credit products, as credit is not considered a 'financial product' for the purposes of the *Corporations Act 2001*. Mortgage brokers, therefore, are not obliged to have an Australian financial services licence. ASIC has the power to take action against brokers only in relation to misleading or deceptive conduct/advertising.

Instead, the provision of credit is covered by the states under the Uniform Consumer Credit Code (UCCC). However, as the UCCC does not regulate the provision of advice on credit, some states have introduced separate legislation to cover mortgage broker activities. This legislation focuses mainly on disclosure, with only Western Australia licensing mortgage brokers.

In late 2004, the Ministerial Council of Consumer Affairs (MCCA) – a working committee comprising the Federal Parliamentary Secretary to the Treasurer and state Ministers of Consumer Affairs – released a discussion paper with proposals for uniform state-based regulation of finance brokers. The proposals, which would apply to all finance brokers (other than those who only broker business loans to large firms or amounts over $2 million), include a licensing scheme, minimum competency requirements, full disclosure of fees and commissions, and participation in a dispute resolution scheme approved by ASIC. Recommendations by brokers would also have to meet quality standards, with brokers obliged to provide customers with a written explanation of their recommendations.

A draft bill based on the MCCA proposal is currently being prepared by NSW, with a view to this draft being used as a template for the other states. Given the delays in the process, however, a couple of states have proposed interim codes of conduct for finance brokers until the uniform legislation is implemented. The delays have also prompted the House Standing Committee on Economics, Finance and Public Administration to recommend that mortgage brokers be regulated under Commonwealth legislation. Either approach would result in a standardised framework for dealing with licensing, conduct and disclosure. The Reserve Bank supports calls for such a framework to be established as quickly as possible.

Credit Reporting

After extensive consultation, the Australian Law Reform Commission (ALRC) released a discussion paper in mid September reviewing the application of the *Privacy Act 1988* to credit reporting. Credit reporting is the practice of providing information about an individual's credit worthiness to banks, finance companies and other credit providers through credit reporting agencies. The Privacy Act, among other things, limits the information that these agencies are permitted to keep and regulates the storing and provision of credit information. In Australia, there are three main credit reporting agencies – Veda Advantage (formerly Baycorp Advantage), Dun and Bradstreet, and the Tasmanian Collection Service. These agencies are privately owned, in contrast to some other countries where the agencies are publicly run.

Under the current model, an individual's credit file contains name, address, employer details and a record of credit applications made by the person in the past five years. It also includes information about defaults (payments overdue by 60 days or more) during the past five years, irrespective of whether the debt is subsequently repaid. Dishonoured cheques with a value of more than $100 are also recorded, as are bankruptcy orders and relevant court judgements.

The more comprehensive model proposed by the ALRC would include the information currently collected, plus selected details of loan accounts, such as when an account was opened and what credit limit was approved. In addition, the ALRC is proposing that individuals can report to a credit reporting agency that they have been the victim of identity theft, so that this information is available to any potential credit provider. The Commission did not support calls from some credit reporting agencies and credit providers for additional information, including payment histories and current balances, to be recorded.

The ALRC's proposals seek to balance the benefits of having a broader range of credit information available to lenders, against the potential cost to individual privacy, concerns about the accuracy of information, and the potential for the information to be misused. While, in principle, more information should improve the ability of a lender to assess whether a borrower will be able to repay the credit, the Commission was concerned about the accuracy of the data collected by credit reporting agencies, and how disputes over the information might be addressed. The ALRC's proposal includes a requirement that any credit provider who gives information about credit defaults to a credit reporting agency must belong to an approved external dispute resolution scheme.

The ALRC is seeking submissions on these proposals by 7 December 2007. The final report and recommendations are scheduled to be given to the Attorney-General by March 2008. The ALRC has suggested that after five years of operation, this approach to credit reporting should be reviewed.