2. The Australian Financial System

A challenge for the Australian banking system during the past six months was dealing with the market volatility and associated drying up of some credit markets in late 2011 related to the European sovereign debt problems. Compared with the pre-crisis period, Australian banks were in a better position to cope with this disruption given the improvements they had made to their capital and funding positions in recent years. Deposits have also been continuing to grow faster than credit, reducing the size of banks' wholesale funding task. As outlined in 'The Global Financial Environment' chapter, global market sentiment has improved since late 2011 and long-term unsecured funding markets have reopened. The Australian banks have taken advantage of this by issuing a sizeable amount of bonds since the beginning of the year, including covered bonds. While spreads are still relatively high, the banks have been able to make significant inroads into their expected wholesale funding requirements for the year, and thereby put themselves in a better position to cope with any renewed funding strains, should they occur. In response to higher funding costs, banks have recently been lifting the interest rates on some loans relative to the cash rate.

While the banks continued to record robust profits in their latest half-year reporting periods, the slow credit growth environment is likely to limit the pace of future profit growth, particularly as the reductions in bad and doubtful debts that had boosted profitability in recent years appear largely to have run their course. In this environment, banks have been looking to bolster their profitability through cost cutting and productivity improvements, with a number of them recently announcing plans to reduce staff numbers. To the extent that these job cuts are in lending and sales, they align with the weaker activity in these areas. If they were to be in risk management or operational areas, however, the performance of these areas could be compromised.

Banks' asset performance improved a little over the second half of 2011, but remains weaker than in the years leading up to the crisis. If economic conditions were to deteriorate materially, this would mean that banks are in a less favourable starting position in terms of their asset quality than a few years ago. That said, Australian banks' overall loan impairment rates are relatively low, and exposures to the euro area, particularly to the countries experiencing the greatest financial stress, remain very low.

Profitability in the Australian general insurance industry was somewhat subdued in the second half of 2011 following further natural disasters, even though the claims from these events were not on the same scale as the natural disasters in late 2010 and early 2011. The negative impact of these catastrophe events on insurers' underwriting results was also partly offset by stronger investment income. The costs of renewing property reinsurance programs have gone up significantly after the spike in catastrophe claims last year, and insurers have been passing these costs on to policyholders through higher premiums.

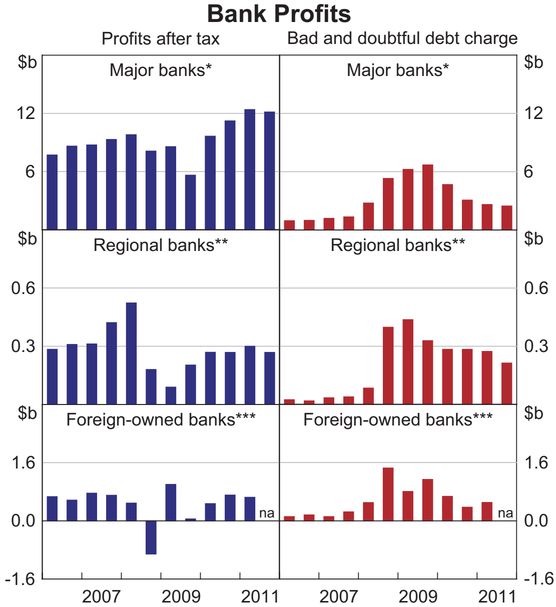
Banking System Profits

The four major banks reported aggregate headline profits after tax and minority interests of $12.1 billion in their latest available half-yearly results (Graph 2.1 and Table 2.1). This result was around $1 billion (8 per cent) higher than in the same period a year earlier but a little below the result from the previous half year. In annualised terms, the average return on equity in the latest half year was about 16 per cent, slightly higher than in the same period a year earlier, and broadly in line with the pre-crisis average (Graph 2.2).

The increase in profitability over the year was driven by a 6 per cent rise in net interest income, which was a stronger rate of growth than in recent years, together with broadly flat operating expenses. The growth in net interest income reflected a slightly wider average net interest margin over the year, combined with modest growth in interest-earning assets (Graph 2.3). More recently, the banks' net interest margins have come under pressure from a rise in funding costs relative to the cash rate and increased holdings of liquid assets. In February, three major banks reported their December quarter 2011 trading updates, which all showed contractions in their group margins recently of between 5 and 10 basis points.

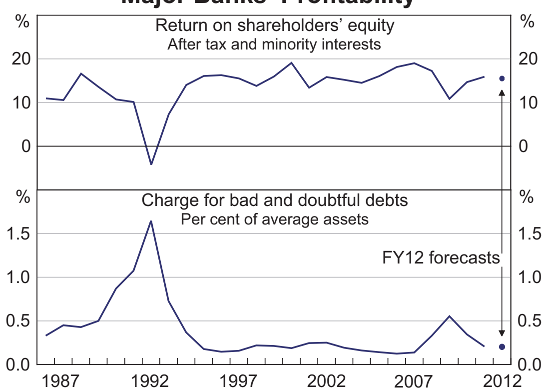
Over the year to the latest half-year reporting period, the major banks' non-interest income fell by 4 per cent, as volatility in financial markets reduced earnings from their trading and wealth management operations. Partly offsetting this, these banks recorded a 5 per cent rise in their fee

Graph 2.1
Bank Profits



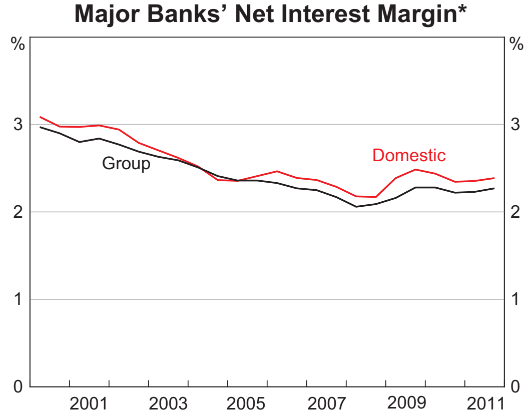
* ANZ, NAB and Westpac report half yearly to March and September, while CBA reports to June and December
** Suncorp Bank and Bendigo and Adelaide Bank report half yearly to June and December, while Bank of Queensland reports to February and August
*** All results are half year to June and December
Sources: APRA; RBA; banks' annual and interim reports

Graph 2.2
Major Banks' Profitability*



* From 2006, data are on an IFRS basis; prior years are on an AGAAP basis
Sources: Credit Suisse; Deutsche Bank; Nomura Equity Research; RBA; UBS Securities Australia; banks' annual and interim reports

Graph 2.3
Major Banks' Net Interest Margin*



* From 2006, data are on an IFRS basis; prior years are on an AGAAP basis; excludes St. George and Bankwest prior to the first half of 2009
Sources: RBA; banks' annual and interim reports

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

	2010 $billion	2011 $billion	Change $billion
Income			
Net interest income	23.8	25.3	1.5
Non-interest income	11.0	10.6	–0.4
Expenses			
Operating expenses	16.7	16.8	0.2
Bad and doubtful debts	3.1	2.5	–0.6
Profit			
Net profit before tax	15.0	16.6	1.6
Net profit after tax and minority interests	11.2	12.1	0.9

(a) Half year to September for ANZ, NAB and Westpac; half year to December for CBA
Sources: RBA; banks' annual and interim reports

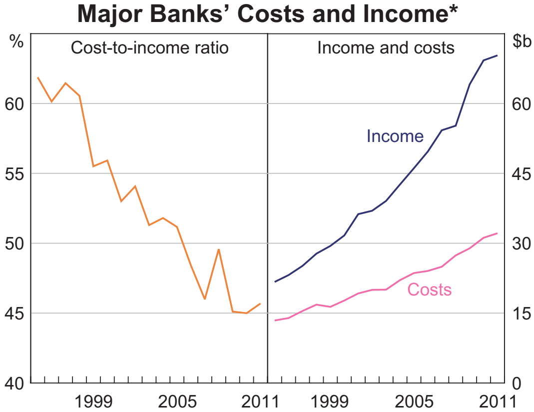
and commission income, the largest component of non-interest income. Overall, underlying revenue growth was steady at around 3 per cent over the year.

Also supporting the increase in the major banks' profits over the year was a further reduction in bad and doubtful debt charges. These charges totalled around $2.5 billion in the latest half-year results, down about 20 per cent over the same period a year earlier but broadly in line with the previous half year. Equity market analysts expect that bad debt charges have now troughed and that they will drift up a little over the coming year. Given that banks' non-performing assets remain elevated, their future profit growth could be reduced if the current stock of provisions is insufficient for future losses.

In an environment of slow loan growth, banks are increasingly looking at ways to raise productivity and reduce costs in order to maintain profit growth. As staff-related expenses represent the largest component of their cost base, some of the major banks have recently announced job cuts and plans to move more technology and back-office processing to lower-cost locations, often offshore. The major banks' cost-to-income ratios have already declined significantly over the past decade and are fairly low by international standards (Graph 2.4).

In aggregate, the regional Australian banks' latest half-yearly profits were similar to the same period a year earlier. Compared with the previous half year though, profits fell slightly, mainly due to a large write-off by one bank. The outlook for regional banks' bad and doubtful debt charges is mixed, and accordingly, their profit outlooks differ over 2012. The foreign-owned banks operating in Australia recorded an increase in aggregate profits in their latest half-yearly results compared with a year earlier. This was driven by a fall in the charge for bad and doubtful debts at a few foreign bank branches, although this was partially offset by a rise at several

Graph 2.4
Major Banks' Costs and Income*



* From 2006, data are on an IFRS basis; prior years are on an AGAAP basis; includes St. George and, from 2009, Bankwest
Sources: RBA; banks' annual and interim reports

other banks. In aggregate, the profits of the credit unions and building societies (CUBS) declined in their latest half-yearly results, although individual results were mixed. The composition of the CUBS sector is changing as a few of the larger ones have recently received APRA approval to call themselves mutual banks.

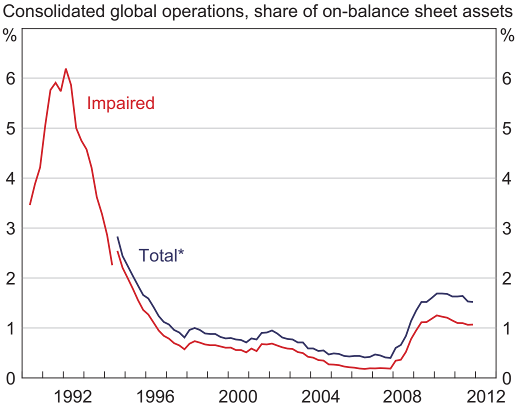
Asset Performance

Banks' asset performance improved slightly over the second half of 2011 but remains worse than in the years leading up to the 2008–2009 crisis. On a consolidated group basis, the ratio of non-performing assets to total on-balance sheet assets fell to 1.5 per cent over the December half, after hovering around 1.7 per cent over 2010 and much of 2011 (Graph 2.5). The recent improvement was driven by a fall in the share of loans classified as past due (in arrears but well secured), while the share of loans classified as impaired (not well secured and where repayment is doubtful) was broadly unchanged at around 1.1 per cent. While the banks' total non-performing assets ratio remains nearly 90 basis points above its average over the decade prior to the crisis, it is still well below the early 1990s peak of over 6 per cent, and it also compares favourably with the ratios of some North Atlantic banking systems (see Graph 1.19 in 'The Global Financial Environment' chapter).

It is notable that quarterly inflows of newly impaired assets have been relatively constant over the past two years, at a much higher level than prior to the crisis (Graph 2.6). During 2011, the rate at which loans were moving out of impairment due to write-offs or 'curing' was similar to the inflows of newly impaired assets, resulting in little change in the level of impaired assets. The apparent stickiness in banks' impaired assets over the past few years could reflect a number of factors, including the pressures some business borrowers are facing from the high exchange rate and subdued domestic retail spending, and recent weakness in house prices making it harder for mortgage borrowers in difficulty to refinance. Were impaired assets to stay at their current level, it would mean that, if economic conditions deteriorated, banks' asset performance would be starting from a weaker position than before the crisis.

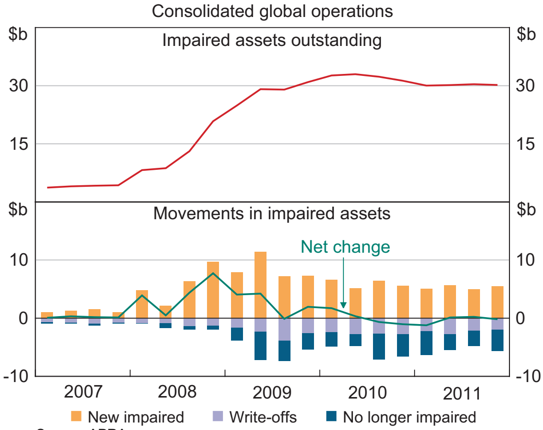
In the banks' domestic portfolio, the ratio of non-performing loans to total on-balance sheet loans fell slightly over the second half of 2011, to 1.7 per cent, about 20 basis points below its 2010 peak (Graph 2.7). The decline in this ratio since 2010 has partly been due to the business loan portfolio, where the non-performing share has fallen from a peak of 3.7 per cent in late 2010 to 3.2 per cent in December 2011. Even so, the share of business

Graph 2.5
Banks' Non-performing Assets
Consolidated global operations, share of on-balance sheet assets



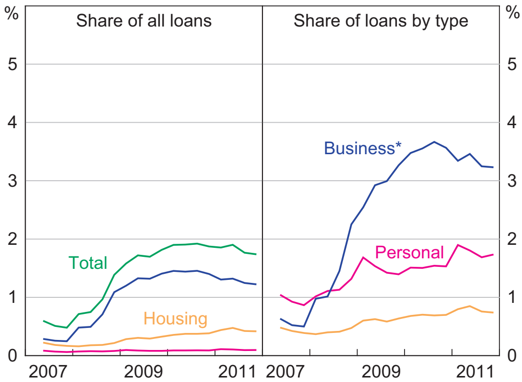
* Includes assets 90+ days past due that are well secured
Source: APRA

Graph 2.6
Banks' Impaired Assets
Consolidated global operations



Source: APRA

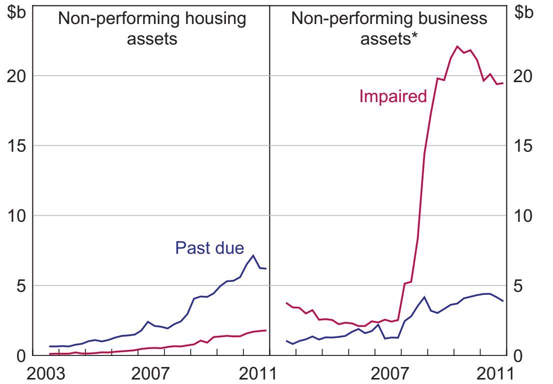
Graph 2.7
Banks' Non-performing Assets
Domestic books



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

Source: APRA

Graph 2.8
Banks' Asset Performance
Domestic books



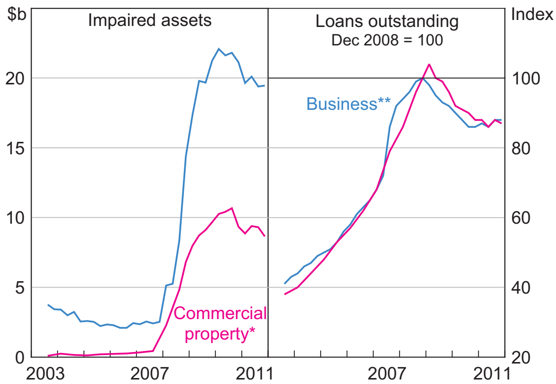
* Includes lending to financial businesses, bills and debt securities and other non-household loans

Source: APRA

assets that is non-performing is still significantly higher than in the banks' housing and personal loan portfolios. For housing loans, the non-performing share has trended up over the past few years, though it did come down a little in the second half of 2011, to around 0.7 per cent in December, driven by a fall in past due loans. Though they still account for only a small share of banks' total non-performing housing loans, impaired housing loans have drifted up in recent years, consistent with the weakness in housing prices in many parts of the country (Graph 2.8). According to industry liaison, past due housing loans have declined partly because some banks have implemented more concerted collections processes. Allowing borrowers to stay in arrears when house prices are falling is not in the long-term interests of the borrowers or the bank.

Troubled commercial property exposures continue to be the key contributor to the high impairment rate in the banks' domestic business loan portfolio. The value of banks' commercial property loans that are impaired has declined by about 20 per cent since peaking in September 2010, although it remains high at around $9 billion (compared with total impaired business loans of around $20 billion) (Graph 2.9). Reflecting banks' continued caution towards commercial property lending, the stock

Graph 2.9
Banks' Asset Performance
Domestic books



* Consolidated Australian operations; sample of 26 banks

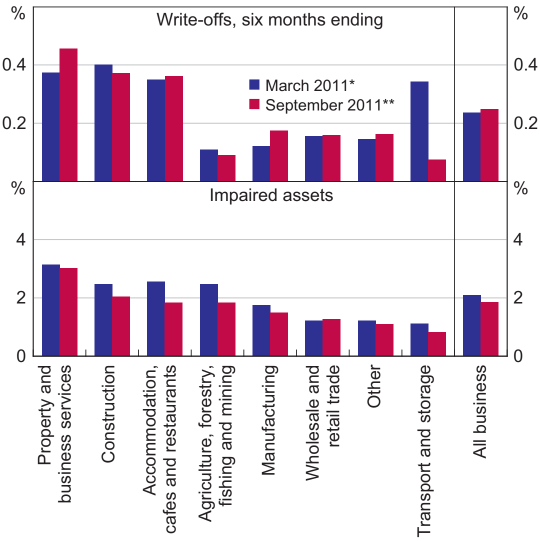
** Domestic books; all banks; includes lending to financial businesses, bills and debt securities and other non-household loans

Source: APRA

of their commercial property exposures has been broadly unchanged over the past year, and is around 15 per cent below its early 2009 peak.

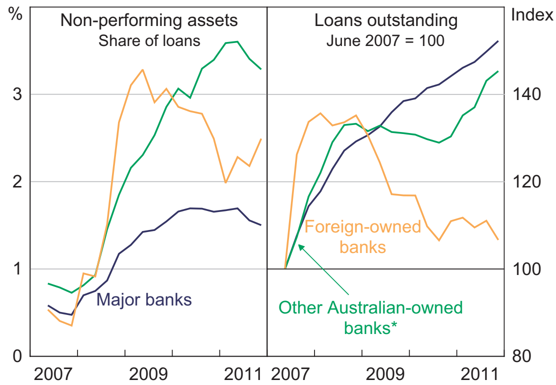
The major banks' Basel II Pillar 3 disclosures provide more detail on the industry breakdown of impaired business loans and write-offs. Impairment rates declined across most industries during the six months to September 2011, but particularly for the accommodation, cafes and restaurants; agriculture, forestry, fishing and mining; and construction sectors (Graph 2.10). Loans to the property and

Graph 2.10
Asset Performance by Industry
Major banks' global operations, per cent of industry exposures



* June 2011 for CBA
** December 2011 for CBA
Source: Banks' Basel II Pillar 3 reports

Graph 2.11
Banks' Asset Performance and Credit
Domestic books



* Includes mutual banks from September 2011
Source: APRA

business services sector (incorporating commercial property) still have the highest impairment rate. This sector continued to have an above-average write-off rate during the six months to September 2011, along with the construction and accommodation, cafes and restaurants sectors.

The major banks and smaller Australian-owned banks were behind the improvement in banks' domestic asset performance in the second half of 2011 (Graph 2.11). By contrast, the share of non-performing assets on foreign banks' books increased, although this was largely attributable to one foreign banking group. The non-performing loan ratio for CUBS was broadly unchanged over this period and remains much lower than that for the banks, partly because loans to households account for a larger share of CUBS' loans.

The performance of the banks' overseas assets improved over the past year. After peaking in mid 2010, the value of non-performing overseas assets declined by 16 per cent to around $9 billion in December 2011 (around 0.3 per cent of the banks' consolidated assets). For the major banks' New Zealand operations, which account for about 40 per cent of their foreign exposures, asset performance has been improving over recent quarters in line with better economic conditions in New Zealand. Asset performance at the banks' UK operations, which account for around 20 per cent of their foreign exposures, remains weaker.

With the recent focus on the problems in Europe, it is useful to note that Australian-owned banks continue to have very limited direct exposure to the sovereign debt of the euro area countries regarded as being most at risk (Table 2.2). Their exposures to euro area banks are also quite low, at around 1 per cent of their total consolidated assets as at September 2011. Most of these exposures are to banks in the larger euro area countries. Australian-owned banks' exposures to banks in the euro area countries that have faced the most acute fiscal problems remain very limited.

Lending Growth and Credit Conditions

Banks continued to record fairly modest growth in their domestic loan books over the past six months. In annualised terms, bank credit grew by about 5 per cent over the six months to January, broadly in line with the average growth rate over the previous

Table 2.2: Australian-owned Banks' Claims on the Euro Area
Ultimate risk basis, as at September 2011

	Total		*of which:* Banks	Public sector	Private sector
	$billion	Per cent of assets	Per cent of assets	Per cent of assets	Per cent of assets
Euro area	**55.4**	**1.8**	**1.0**	**0.2**	**0.6**
of which:					
Greece, Ireland, Italy, Portugal and Spain	5.2	0.2	0.0	0.0	0.1
France, Germany and the Netherlands	44.8	1.5	0.9	0.1	0.5

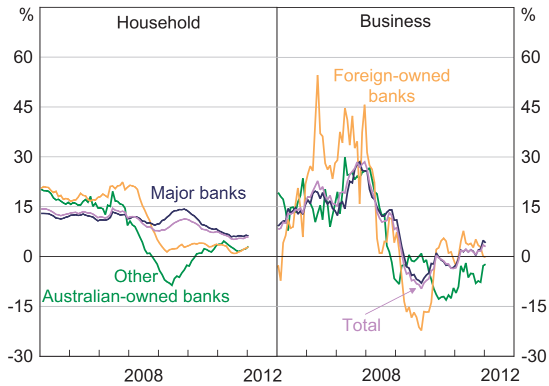
Source: APRA

three years. As noted in the chapter on 'Household and Business Balance Sheets', the household and business sectors have been cautious in their borrowing behaviour. According to industry liaison, lending growth is expected to remain at similar levels for some time due to subdued demand for credit.

Bank lending to households grew by about 6 per cent in annualised terms over the six months to January 2012, broadly similar to growth in the previous six months (Graph 2.12). The foreign-owned and smaller Australian-owned banks have continued to see much slower growth in their household lending than the major banks. After contracting over most of 2009 and 2010, bank lending to businesses recovered a little in 2011, rising by about 3 per cent in annualised terms over the six months to January 2012. The major banks drove this overall rise in business lending; the foreign-owned banks' business credit was broadly unchanged over this period, while it continued to contract for the smaller Australian-owned banks. For further information about the activities of foreign-owned banks in Australia, see 'Box A: Foreign-owned Bank Activity in Australia'.

Housing lending standards appear to have been largely unchanged over the past six months. Some banks have recently responded to higher relative funding costs by reducing the interest rate discounts they offer on new housing loans and, in early 2012, most raised their standard variable housing loan rates by around 10 basis points, relative to the cash rate. Mortgage refinancing activity was particularly strong during most of 2011, but has declined in recent months, perhaps reflecting some changes in competitive pressures. In business lending, competitive pressures to loosen lending standards have generally been less intense than in housing lending. In industry liaison, most banks reported only modest interest in lending for commercial property, with credit standards generally remaining tight.

Graph 2.12
Bank Credit Growth
Six-month-ended, annualised



Sources: APRA; RBA

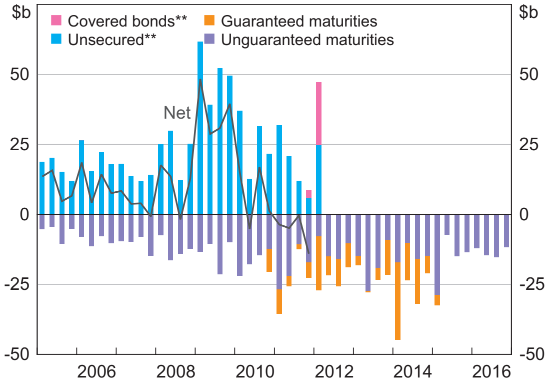
Funding Conditions and Liquidity

The Australian banks faced a tougher funding environment in the second half of 2011, but conditions have improved since the start of this year. Conditions in global wholesale funding markets deteriorated towards the end of 2011, associated with the sovereign debt and banking sector problems in the euro area. During this time, banks were reluctant to issue into such volatile markets, due to price and non-price concerns, and thus issued only about $20 billion in bonds over the second half of 2011, less than half the amount issued in the previous six months (Graph 2.13). Short-term wholesale funding markets remained open to them, and indeed they benefited from the reallocation of US money market funds' investments away from Europe, though there was some shortening of maturities in late 2011 and wider spreads.

As discussed in 'The Global Financial Environment' chapter, funding conditions have improved since late 2011. The Australian banks have taken advantage of this by significantly increasing their bond issuance, raising over $45 billion since the start of the year. Covered bonds issued by the major banks accounted for around $20 billion of this issuance, about 40 per cent of which were issued in the domestic market. The covered bonds have generally been at longer tenors than had previously been the case with unsecured bonds, partly reflecting access to a wider investor base.

The recent pick-up in banks' gross bond issuance was in part a response to the large amount of bond maturities over the early part of this year, particularly government-guaranteed bonds: close to $20 billion were due to mature in the first quarter of 2012. Since December 2011, some banks have also continued to repurchase their guaranteed bonds that had around one year or less left before maturity, although at a slower pace than earlier in 2011. Reflecting these repurchases and maturities, banks' guaranteed wholesale liabilities outstanding have declined to just under $100 billion, down from around

Graph 2.13
Banks' Bond Issuance and Maturities*
A$ equivalent



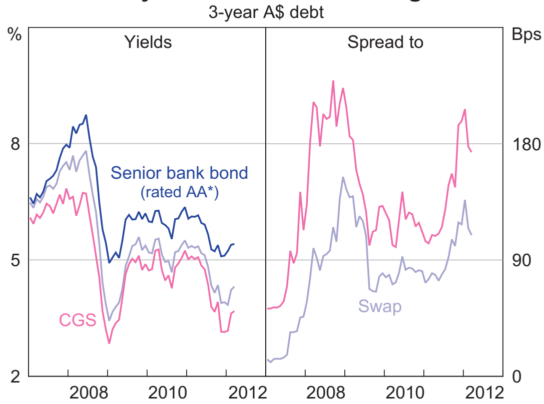
* Excludes 12–15 month paper, considered as 'short-term' under the Australian Government Guarantee Scheme
** March quarter 2012 is quarter-to-date
Source: RBA

$120 billion in August 2011 and $170 billion at their peak in February 2010.

Issuance costs, relative to benchmark rates, generally increased over the second half of 2011, though they have since narrowed. In net terms, spreads on 3-year unsecured bank bonds have increased over the past six months as investors were drawn to Commonwealth Government securities as a safe-haven asset; spreads are now around 55 basis points higher than those on equivalent unsecured bonds in mid 2011, despite narrowing recently (Graph 2.14).

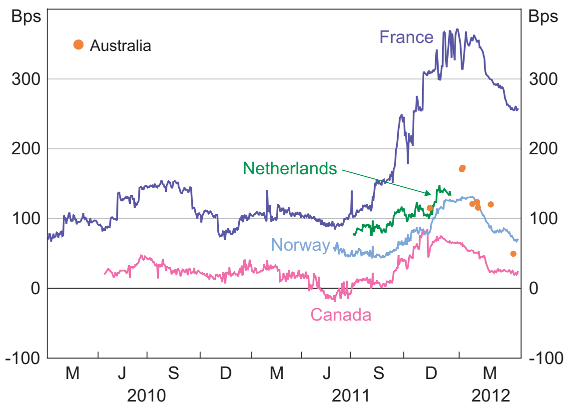
The banks' recent covered bond issuance has been considered to be a relatively expensive source of funds, being only slightly cheaper than senior unsecured bond funding, although spreads were similar to those of many peer banks overseas (Graph 2.15). Secondary market spreads on covered bonds priced in US dollars tightened in early February as market sentiment improved. In the domestic secondary market, spreads on 5-year covered bonds have been trading around 40 basis points tighter than senior unsecured bonds with a similar tenor. Despite the recent narrowing in spreads, the funding costs of both senior unsecured and covered bonds remain elevated. This is partly due to the higher cost

Graph 2.14
Major Banks' Bond Pricing
3-year A$ debt



* S&P downgraded the major Australian banks to AA- in December 2011
Sources: Bloomberg; RBA; UBS AG, Australia Branch

Graph 2.15
Covered Bond Pricing*
Spread to US$ swap, 4–6 year AAA rated



* Non-US$ issuance converted into US$ spreads
Sources: Bloomberg; RBA

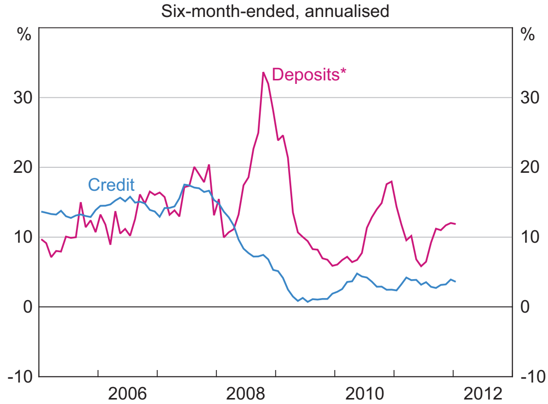
of swapping offshore issuance into Australian dollars as well as ongoing concerns about the euro area.

Given the tensions in wholesale funding markets, banks continued to compete actively for deposits, particularly for term deposits and other types of deposits that are likely to attract a more favourable treatment under the Basel III liquidity rules. Spreads between term deposit rates and market rates have increased over the past six months, and are around historically high levels. Growth in deposits has remained strong, at an annualised rate of 12 per cent during the past six months, and continues to exceed credit growth by a wide margin (Graph 2.16). There has been strong growth in both household and business deposits, and across most types of deposit-taking institutions. Reflecting the intense competition for term deposits, their share of bank deposits has increased from 30 per cent to about 45 per cent since mid 2007, at the expense of transaction and savings account deposits. The reduction in the deposit guarantee limit under the Financial Claims Scheme from 1 February has had no discernible effect on the deposit market.

The strong growth in deposits has allowed banks to reduce their use of short-term wholesale funding further over the past six months (Graph 2.17). In early 2012, the deposit share of bank funding reached its highest level since 1998, at 52 per cent. In contrast, the share of short-term wholesale funding has declined to 20 per cent, compared with 33 per cent at the end of 2007.

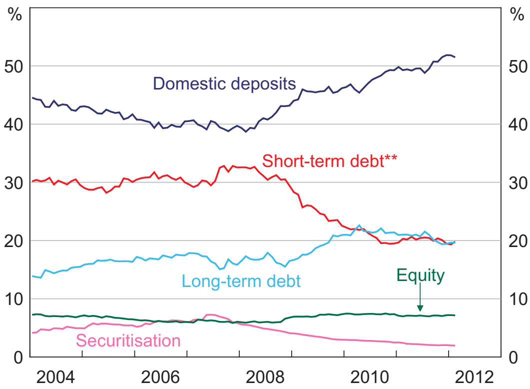
Conditions in residential mortgage-backed securities (RMBS) markets improved during 2011, with issuance for the year as a whole, at $22 billion, the highest since 2007. However, these markets were also affected by the increase in global risk aversion in the second half of 2011, and only two small issues have taken place since the end of November. For the major banks, covered bond issuance could have crowded out RMBS to some extent.

Graph 2.16
Credit and Deposit Growth
Six-month-ended, annualised



* Excludes certificates of deposit, government deposits and foreign currency deposits
Source: RBA

Graph 2.17
Banks' Funding*
Share of total



* Adjusted for movements in foreign exchange rates
** Includes deposits and intragroup funding from non-residents
Sources: APRA; RBA; Standard & Poor's

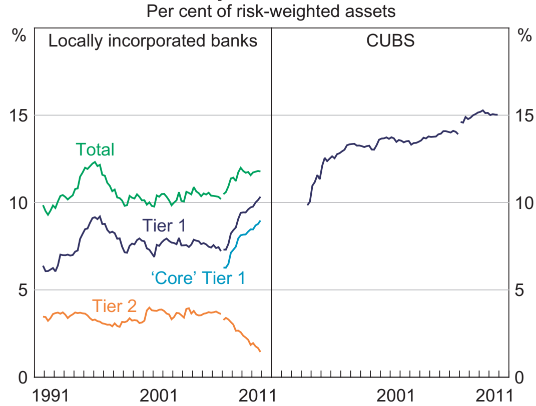
Wholesale funding challenges could persist in 2012 if markets remain prone to bouts of uncertainty and volatility arising from developments in Europe and the slower global growth outlook. If that occurs, these challenges could restrain the scope to increase lending. However, banks can take steps to minimise the effect of further tensions in financial markets, including taking advantage of opportunities to issue debt, staying ahead on their funding requirements and maintaining a strong liquidity position.

After increasing over the past couple of years, the banks' liquid asset position continued to trend up in recent quarters. The major banks' holdings of cash and liquid assets increased to around 10 per cent of their total assets in January 2012. Banks' holdings of internal RMBS also increased slightly over the past six months and now total $150 billion. With the forthcoming Basel III liquidity rules, banks are continuing to assess their required liquid asset holdings and the appropriate mix of these assets.

Capital

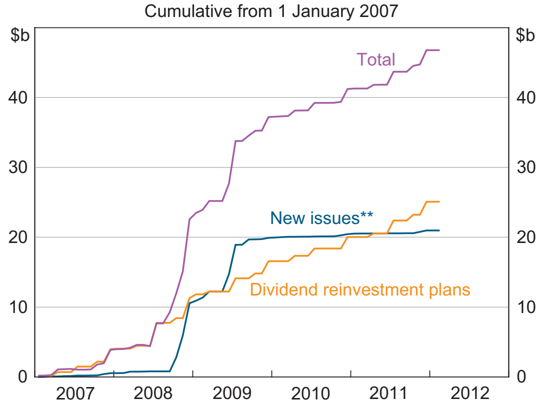
The Australian banking system remains well capitalised: banks' aggregate Tier 1 capital ratio increased by a further 0.3 percentage points over the second half of 2011, to 10.3 per cent of risk-weighted assets (Graph 2.18). The increase was mostly due to dividend reinvestment plans and higher retained earnings (Graph 2.19). A few banks have issued hybrid securities totalling $2.7 billion over the past six months, which have a mandatory common equity conversion trigger, making them eligible as non-common equity Tier 1 capital under the Basel III framework. The increase in the banking system's Tier 1 capital was partly offset by the continued run-off of Tier 2 capital instruments (mainly subordinated debt) that will no longer qualify as capital under Basel III. CUBS have maintained their higher capital ratios: their aggregate Tier 1 capital ratio is around 15 per cent. As the Australian banking system is already

Graph 2.18
Capital Ratios*
Per cent of risk-weighted assets



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

Graph 2.19
Major Banks' Equity Raisings*
Cumulative from 1 January 2007



* Includes St. George
** Includes new placements and employee share purchase plans
Source: ASX

well placed to meet the Basel III capital requirements, APRA has proposed to implement them ahead of the global timetable.

The Australian banking system's risk-weighted assets increased by about 3 per cent over the second half of 2011. That this is slower than overall balance-sheet growth reflects the ongoing shift in the composition of banks' portfolios towards housing and high-quality liquid assets, such as government bonds, which attract lower risk weights than other assets.

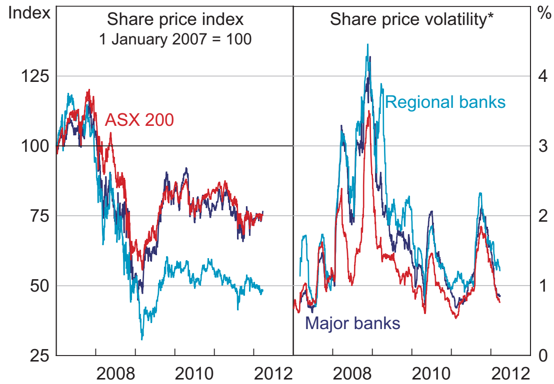
Financial Markets' Assessment

After a period of heightened volatility during the second half of 2011 associated with the turbulence in global financial markets, Australian bank share prices have largely moved sideways over the past few months and generally in line with the broader share market (Graph 2.20). The recent improvement in global market sentiment has also been reflected in Australian banks' credit default swap premia, which have declined from the elevated levels seen in late 2011.

The major Australian banks continue to be viewed relatively favourably by the international credit rating agencies (Graph 2.21). Standard & Poor's (S&P) completed its review of its global bank credit rating methodology in late 2011. The revised methodology places a greater emphasis on perceived economic and funding imbalances as well as the importance of investment banking to a bank's business model. Following the review, S&P changed Australia's 'banking industry country risk assessment', which feeds into individual bank credit ratings, from Group 1 (the least risky) to Group 2 (out of 10 rating groups). Other Group 2 countries include Finland, France, Germany, Japan, the Netherlands and Sweden; only Canada and Switzerland remain in Group 1. Mainly as a result of this change, S&P downgraded its ratings of the major Australian banks by one notch from AA to AA- in December 2011. The decision had minimal market impact as it was well anticipated. Around the same time, S&P also lowered its rating of Bank of Queensland by one notch to BBB (although more recently placed it on positive watch), raised Bendigo and Adelaide Bank's rating by one notch to A-, and retained its A rating for Macquarie Bank although it downgraded its rating for Macquarie Group. S&P's review also affected the ratings of many other banks globally.

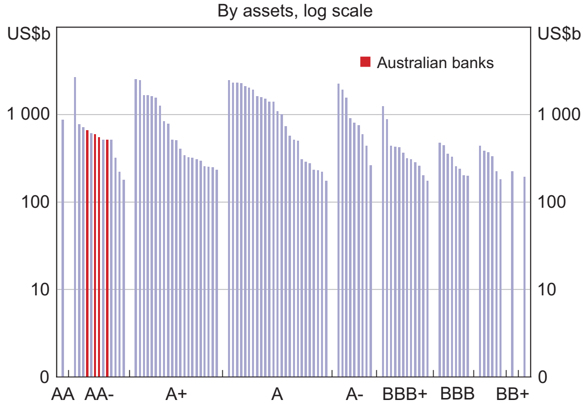
The other major rating agencies have also announced some rating actions on Australian banks since the beginning of the year. As part of a broader review, Fitch reviewed the major banks' and Macquarie Bank's ratings: three of the majors were downgraded to AA-, matching its existing rating for ANZ; and Macquarie Bank was downgraded to A.

Graph 2.20
Financial Market Indicators



* Rolling two-month standard deviation of daily returns
Sources: Bloomberg; RBA

Graph 2.21
Credit Ratings of the Largest 100 Banking Groups*
By assets, log scale



* Holding company ratings; predominantly Standard & Poor's local long-term ratings, unless unrated, then Moody's senior unsecured
Sources: Moody's; Standard & Poor's; *The Banker*

Fitch based these decisions on its reassessment of the risks posed by the banks' reliance on offshore wholesale funding markets and for Macquarie Bank, its exposure to market-oriented income. Macquarie Bank was also downgraded by Moody's to A2 (equivalent to S&P's A rating) for similar reasons. Moody's downgraded Bank of Queensland to A3 (equivalent to S&P's A- rating) citing concerns over the performance of a small number of large loans and challenges in wholesale funding markets.

General Insurance

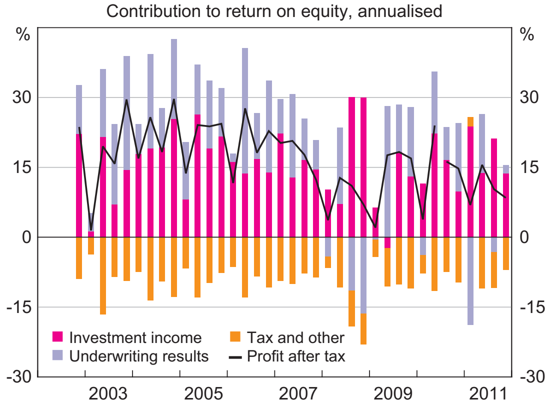
The Australian general insurance industry remains in a sound financial position despite the claims impact of the natural catastrophe events over the past 18 months and weaker investment conditions. The return on equity for the industry was a little below average in the second half of 2011 (Graph 2.22). However, the industry remains well capitalised, holding capital equivalent to 1.8 times the minimum capital requirement as at December 2011. Reflecting their profitability and robust capital ratios, the major insurers continue to be rated A+ or higher by S&P.

While there were further natural disasters in the second half of 2011, the claims estimates from these events were lower than those in late 2010 and early 2011. The Insurance Council of Australia currently estimates the value of the claims arising from the storms in Victoria on Christmas Day and the recent flooding in south-west Queensland at nearly $800 million in total, which is well below the estimate of around $4 billion for the flooding events in 2010/11 and Cyclone Yasi. However, the accumulation of claims from a number of events meant that some insurers still exceeded their catastrophe allowances in the second half of 2011, and the industry's underwriting results were weak.

Financial market developments also affected the performance of the insurance industry over the second half of 2011. The value of 'long-tail' insurance liabilities increased because risk-free interest rates (used to discount these liabilities) declined, resulting in increased provisions for claims; this contributed to the small underwriting loss in the September quarter. On the other hand, the same decline in interest rates implied valuation gains, which boosted investment income. Consistent with the recent pressures on their earnings, insurers' share prices generally underperformed the broader market until recently, when they picked up strongly (Graph 2.23).

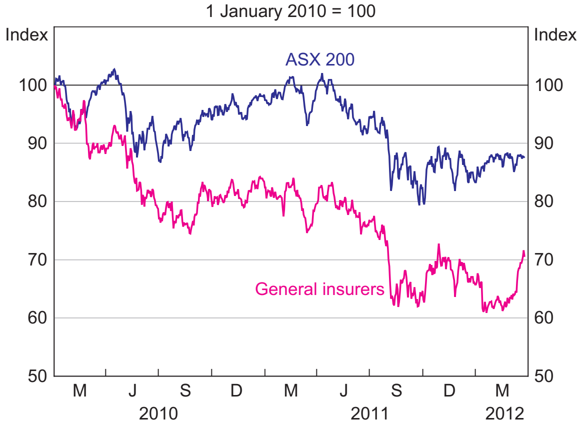
Because reinsurers absorbed much of the large increase in natural disaster insurance claims over the past year or so, insurers have faced much higher prices when renegotiating their reinsurance arrangements; they have also been required to retain more risk in some cases. These higher reinsurance

Graph 2.22
General Insurers' Performance*
Contribution to return on equity, annualised



* Change in prudential reporting requirements from September 2010
Source: APRA

Graph 2.23
General Insurers' Share Prices
1 January 2010 = 100



Sources: Bloomberg; RBA

costs have contributed to insurers raising their premiums, particularly on home building and contents policies.

As noted in the previous *Review*, the Australian Government established the Natural Disaster Insurance Review to examine the availability of natural disaster insurance, and it released its final report in November 2011. The recommendations included that the industry should offer flood cover – using a common definition – as standard in home building and contents policies, and that the government establish an agency to coordinate national flood risk management, including flood mapping, to enhance the industry's understanding of and ability to price for flood risk. Even before the final recommendations were released, a number of insurers had already moved to provide flood cover as standard in their policies.

Conditions in the Australian economy and residential property market have supported the two largest providers of lenders' mortgage insurance (LMI), Genworth Australia and QBE LMI, in remaining profitable in the past year. QBE LMI continues to be rated AA- by S&P. Genworth Australia has also maintained its AA- credit rating from S&P even though its loss-making US parent was downgraded in January. Genworth has announced plans to sell up to 40 per cent of its Australian unit through an initial public offering of shares in the second quarter of 2012.

Managed Funds

Unconsolidated assets of the managed funds industry fell by 6 per cent in annualised terms over the six months to December 2011, to $1.8 trillion (Table 2.3). This was well below the average annual growth of 7 per cent over the past decade, and reflects the difficult investment market conditions in the second half of 2011. All types of managed funds recorded falls in their funds under management over the half year to December 2011, with the largest falls occurring at public unit trusts. The assets of superannuation funds, which account for 70 per cent of the unconsolidated assets of managed funds, fell by almost 5 per cent in annualised terms over the half year.

Equity investments were the biggest contributor to the decrease in managed funds' assets, as equity prices declined amid financial market turbulence in the September quarter of 2011; some explicit shifting of portfolios might also have occurred. Across all managed funds, the allocation to equities

Table 2.3: Assets of Domestic Funds Management Institutions[(a)]
December 2011

	Level	Share of total	Six-month-ended annualised change	
			Jun 11	Dec 11
	$billion	Per cent	Per cent	Per cent
Superannuation funds	1 258	70	6.6	–4.9
Life insurers[(a)]	228	13	2.9	–6.0
Public unit trusts	263	15	–6.1	–13.4
Other managed funds[(b)]	38	2	–12.4	–0.4
Total (unconsolidated)	**1 786**	**100**	**3.6**	**–6.3**
of which:				
Cross investments	376	–	1.5	–10.4
Total (consolidated)	**1 411**	**–**	**4.2**	**–5.1**

(a) Includes superannuation assets held in statutory funds
(b) Cash management trusts, common funds and friendly societies
Sources: ABS; RBA

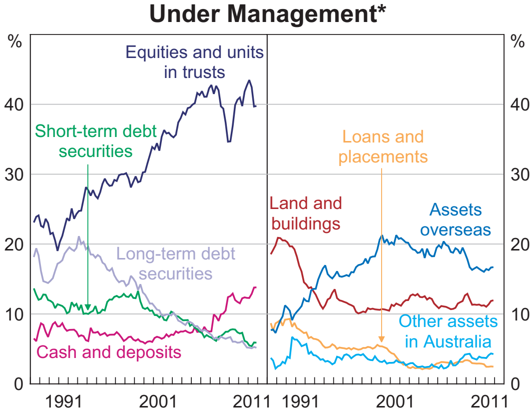
and units in trusts fell to 40 per cent of assets under management, down from 43 per cent in early 2011 (Graph 2.24). Managed funds' holdings of cash and deposits increased over the period and now make up 14 per cent of assets under management, up 6 percentage points since 2007. The increased allocation to cash and deposits may partly reflect a desire to hold assets with less volatile returns and greater capital protection.

Over the half year to December 2011, superannuation funds' financial performance was mixed, recording negative returns in the September quarter, but positive returns in the December quarter. The relatively good performance of deposits and debt securities dampened the impact of equity market losses. Broadly steady net contribution inflows were not enough to offset the $44 billion loss of funds' investment value during the financial market turbulence in the September quarter (Graph 2.25).

Life insurers' investments mirrored the performance of superannuation funds: investment losses drove a 6 per cent decline in annualised terms over the second half of 2011 (Graph 2.26). The fall in the value of equities mainly affected life insurers' superannuation business, but only had a small impact on the profitability of the industry during the second half of 2011. Life insurers remain well capitalised, holding the equivalent of 1.4 times the minimum requirements as at December 2011.

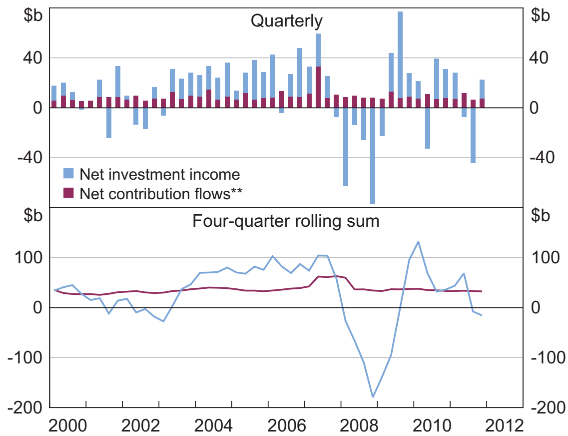
Outside of superannuation funds and life insurers, public unit trusts account for the majority of the remaining managed fund assets, though their share of all funds' assets is declining. The financial turmoil in the second half of 2011 particularly affected equity trusts, which accounted for most of the decline in public unit trusts' assets over this period.

Graph 2.24
Allocation of Domestic Funds Under Management*



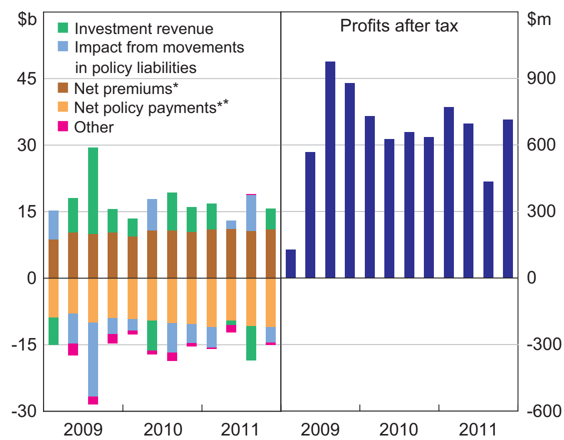
* Funds under management are on a consolidated basis; excluding 'assets overseas', individual asset types represent investments in Australia
Source: ABS

Graph 2.25
Superannuation Funds' Financial Performance*



* From December 2004, data cover entities with at least $50 million in assets only
** Total contributions received by funds plus net rollovers minus benefit payments
Source: APRA

Graph 2.26
Life Insurers' Financial Performance



* Sum of net policy revenue, premium-related fees and net policy revenue recognised as a deposit
** Sum of net policy expenses and net policy expenses recognised as a withdrawal
Source: APRA

The Australian managed funds and banking sectors are interconnected, with one of the main linkages being managed funds' holdings of bank equity and liabilities. This interconnection is beneficial in that managed funds are a source of funding for banks, and banks provide investment opportunities for funds. On the other hand, it could also represent a concentrated exposure to each other. Managed funds' holdings of deposits, debt securities issued by banks, and bank equity have generally been increasing over the past few years, and now account for around 22 per cent of their financial assets (Graph 2.27). To the extent that banks are under market and regulatory pressure to lengthen the term of their funding and access funding from more reliable and stable sources, the increasing allocation of managed fund investments to bank liabilities has the potential to provide banks with a more stable source of funding compared with offshore wholesale investors.

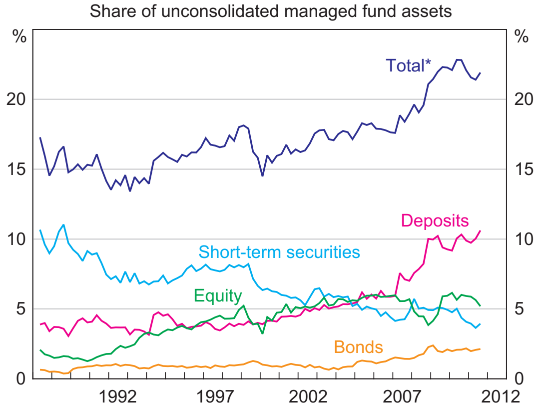
The claims of superannuation funds on banks, which includes short-term and long-term debt securities, deposits and equity holdings, have increased by over $100 billion since 2007, representing a 6 percentage point increase in the share of superannuation funds' assets. Bank-issued bonds remain a small component of superannuation funds' claims on banks, but they have grown noticeably since 2007. Much of the overall growth has been in deposits, which may be due to a growing appetite of superannuation funds to hold less risky assets and to manage their own liquidity needs.

Market Infrastructure

Settlement of high-value payments through the Reserve Bank's payment infrastructure continued to function smoothly over the past six months. The volume of transactions settled in Australia's high-value payment system, the Reserve Bank Information and Transfer System (RITS), continued its upward trend over 2011. However, the average value of transactions settled in RITS remains subdued, falling to $158 billion per day in the March quarter to date, which is about 22 per cent below the pre-crisis peak (Graph 2.28).

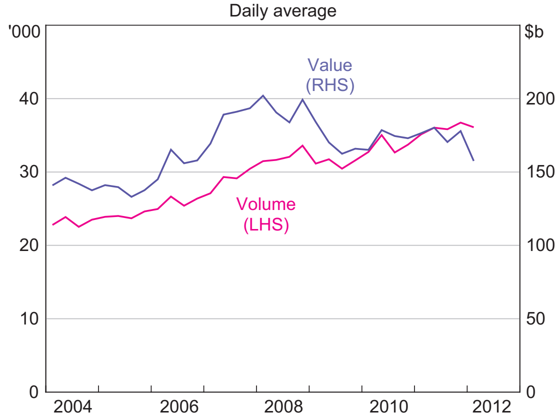
For low-value (generally retail) payments, the Reserve Bank has developed new services which will further enhance the efficient and stable operation of payments infrastructure. These are two complementary services to assist settlement of low-value payments systems (i.e. those for cheques, card payments and direct-entry transactions). These services aim to: reduce the risk associated with the settlement arrangements for low-value payments; improve timeliness and efficiency; and support ongoing industry innovation.

Graph 2.27
Managed Funds' Claims on Banks
Share of unconsolidated managed fund assets



* Refers to the total financial claims of managed funds against banks
Source: ABS

Graph 2.28
RITS Settled Payments*
Daily average



* Real-time gross settlement payments; March 2012 is quarter-to-date
Source: RBA

Financial institutions that participate in clearing arrangements for low-value payments systems process transactions throughout the day and, in some systems, exchange files periodically containing payment information. At the end of each day, each financial institution that settles directly sends a summary of its bilateral obligations to the Reserve Bank, which calculates each financial institution's multilateral net position. These multilateral net positions are then settled in RITS at around 9 am the next day.

The Reserve Bank introduced the Low Value Clearing Service (LVCS) in June 2010 to facilitate the transfer of files related to the clearing of low-value payments. The Reserve Bank acts as a central point through which clearing files can be routed from one participant to another regardless of the communication network used by an individual participant. The Reserve Bank has also developed the RITS Low Value Settlement Service (LVSS) to replace end-of-day advices of settlement obligations with individual settlement instructions sent to RITS at the time that payments clearing takes place. In the future, this will enable a move to more timely and frequent settlement of payment obligations through these systems. This reduces the credit exposure that arises when payments are posted to customer accounts ahead of interbank settlement. The first low-value system to migrate to the LVSS will be that for direct-entry transactions. This is targeted for May 2012. Other low-value systems are expected to migrate by the end of October 2012. Initially, settlement will continue to occur on a multilateral, next-day basis.

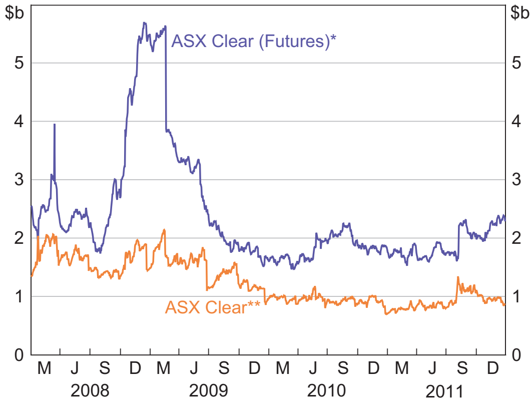
The Reserve Bank has responsibility for promoting an efficient and stable payments system, which includes promoting the operational reliability of payment systems. With continued rapid growth in the value of payments settled across electronic retail payment systems, and following a number of operational incidents, the Reserve Bank recently announced that it will be formalising its requirements for the reporting of major retail payments system incidents. ADIs that provide retail payments services and operate Exchange Settlement accounts with the Reserve Bank will be required to report significant incidents in their retail payments operations to the Reserve Bank. This will supplement the existing reporting of high-value payments incidents by RITS members. Operational resilience is primarily an issue for payments system efficiency. However, there could be implications for financial stability if material concerns about operational resilience occurred during a period of financial stress.

The two ASX central counterparties, ASX Clear and ASX Clear (Futures), centralise and manage counterparty risk in Australia's main exchange-traded equities and derivatives markets. Exposure from this activity is mitigated by margin from participants and mutualised participant contributions to a default fund. Currently, margin is collected on derivatives positions only, although ASX Clear is in the process of implementing margining of equities.

Margin rates are based on historical price volatility and accordingly, margin held at the central counterparties provides an indication of the aggregate risk of open positions held. At the start of the second half of 2011, margin held remained at low levels relative to recent years. It increased noticeably in August after heightened market volatility led the central counterparties to raise margin rates on a number of contracts (Graph 2.29). Increased volatility also led to a temporary increase in open positions, which were mostly closed out following the peak in volatility. Margin held by ASX Clear (Futures) picked up again after further margin rate increases in October.

In early November, ASX Clear and ASX Clear (Futures) declared three clearing participants in default; all were subsidiaries of MF Global, a US-based company specialising in brokerage services. The default declaration was a result of the parent company filing for bankruptcy in the United States, after its exposures to European sovereign debt generated critical funding problems. Of MF Global's Australian clearing participants, that with the largest position,

Graph 2.29
Central Counterparty Margins



* Initial margin
** Derivatives initial and mark-to-market margin
Source: ASX

MF Global UK, had a relatively small portfolio at ASX Clear (Futures) comprising financial and agricultural derivatives, which were mostly held on behalf of clients. Nevertheless, as it accounted for a large proportion of the relatively small wool and grain derivatives markets, ASX Clear (Futures) suspended trading in these markets on the day of the default, though these markets reopened the next day. The ASX central counterparties were well collateralised against MF Global exposures at all times, and these exposures were able to be closed out within two weeks.