2. The Australian Financial System

As noted in the chapter on 'The Global Financial Environment', concerns about the sustainability of sovereign debt and the strength of the global economic recovery have intensified over August and September. This has resulted in a tightening in global credit markets and heightened volatility in the Australian share market as well as those overseas. Australian bank share prices fell sharply in early August and remained volatile during September; they are now around 10 per cent below their levels at the start of August. Relative to its pre-crisis position, though, the Australian banking system is better placed to cope with such adverse shocks. It has higher levels of capital, makes less use of short-term wholesale funding and makes greater use of deposits as a source of funding. Bank profitability continues to improve following the financial crisis, largely due to falls in charges for bad and doubtful debts.

On the other hand, should conditions deteriorate materially, the effect on the banking system would occur from a somewhat weaker starting position on asset quality than had been the case at the beginning of the crisis. Despite the favourable macroeconomic environment and low unemployment in Australia, the proportion of non-performing assets on banks' balance sheets remains close to its recent peak, though it is well below the levels seen in the early 1990s and those currently experienced in many other developed countries. The bulk of non-performing housing loans are well collateralised and therefore not likely to lead to material loan losses. However, with house prices softening, borrowers cannot sell their property as easily if they get into payment difficulty, meaning fewer cases of arrears are likely to be resolved by the sale of the property than when prices were rising. It may also be harder for borrowers in difficulty to refinance with another lender, as the non-authorised deposit-taking institution (non- ADI) sector is not refinancing as many existing ADI loans as in the past and, overall, lending standards remain tighter than before the crisis.

Subdued credit growth will affect the outlook for future increases in the profitability of ADIs. In such an environment of low credit growth, it will be important that ADIs do not seek to imprudently expand their balance sheets by easing lending standards, or by taking on excessive risks in unfamiliar markets or products. In these circumstances, shareholders may need to revise their expectations about the future growth in ADI profits.

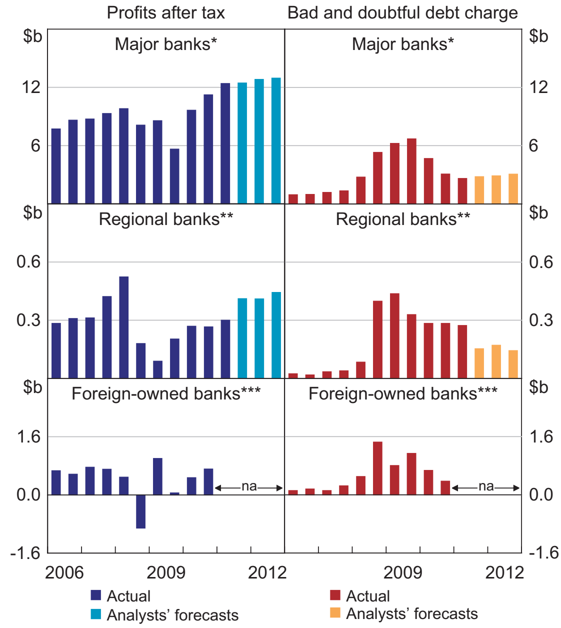
The Australian insurance industry reported lower profits in the March quarter 2011, due to a weaker underwriting result, although this was, in part, offset by stronger investment income, and profits recovered in the June quarter. Insurers coped well with the elevated levels of claims from the natural disasters around the start of 2011, assisted by their robust reinsurance arrangements. Insurers have begun to raise premiums, particularly on home insurance, to cover rises in reinsurance premiums.

Banking System Profits

The four major banks reported aggregate headline profits after tax and minority interests of $12.4 billion in their latest available half-yearly results (Graph 2.1 and Table 2.1). Excluding a one-off tax write-back at one of them, these banks' profits were $1.6 billion

Graph 2.1

Bank Profits



* ANZ, NAB and Westpac report half yearly to March and September, while CBA reports to June and December

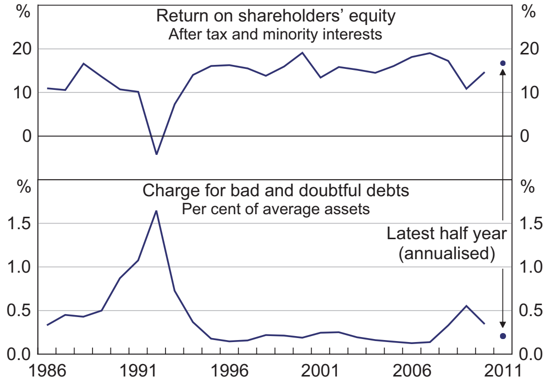
** Suncorp Bank, and Bendigo and Adelaide Bank report half yearly to June and December, while Bank of Queensland reports to February and August

*** All results are half year to June and December

Sources: APRA; Citigroup; Credit Suisse; Deutsche Bank; RBA; UBS Securities Australia; 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: RBA; banks' annual and interim reports

(17 per cent) higher than in the same period a year earlier. The major banks' average return on equity in the latest half year was 17 per cent in annualised terms, which is broadly in line with the pre-crisis average (Graph 2.2). The increase in profitability in the latest half year was largely driven by a further reduction in bad and doubtful debt charges. Underlying revenue growth was steady at around 4 per cent over the same period a year earlier, comparable to the growth rate in the past couple of years, but well down on pre-crisis rates. Aggregate bad and doubtful debt charges were $2.6 billion in the latest half year, down about 60 per cent from the 2009 peak, though still above the pre-crisis average. As discussed further below, the major banks' non-performing assets have levelled out recently, but are yet to show a marked decline from their recent peak.

Net interest income, the main source of income for these banks, rose by 5 per cent over the year, a slower rate of growth than in earlier periods. This reflected

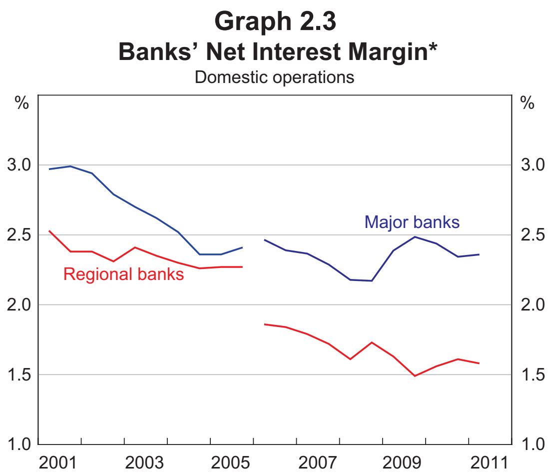
Table 2.1: Major Banks' Half-yearly Profit Results(a)

Consolidated global operations

	2010 $billion	2011 $billion	Change $billion
Income			
Net interest income	23.1	24.2	1.1
Non-interest income	10.7	11.0	0.4
Expenses			
Operating expenses	15.7	16.5	0.8
Bad and doubtful debts	4.7	2.6	–2.1
Profit			
Net profit before tax	13.4	16.1	2.7
Net profit after tax and minority interests	9.6	12.4	2.8

(a) Half year to March for ANZ, NAB and Westpac; half year to June for CBA

Sources: RBA; banks' annual and interim reports subdued growth in interest-earning assets. The average net interest margin was also down slightly over the year, but was broadly steady compared with the previous half year (Graph 2.3). Non-interest income increased by 3 per cent over the year, as a rise in revenue from the banks' wealth management and life insurance operations more than offset lower trading and investment income. The major banks with general insurance operations also reported lower income from this source due to increased claims associated with the natural disasters earlier in the year. However, general insurance income only accounts for a very small share of these banks' operating income.



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

The profitability of the major banks' overseas operations, which account for about one-quarter of their consolidated profits in aggregate, has generally strengthened in the past year. In part, this reflects an improvement in their New Zealand operations, which has been supported by economic recovery and improving asset quality.

The major banks that released their June quarter trading updates in mid August reported mixed profit results for the quarter, characterised by softer trading income and higher net interest margins. Looking ahead, equity market analysts are forecasting more modest increases in the major banks' profits in 2012, as bad and doubtful debt charges are expected to level out and credit growth to remain weak. Analysts believe that if the major banks are to improve their profitability in this environment, they will need to reduce their costs, even though their cost-to-income ratios are already among the lowest in the world. The major banks' headline cost-to-income ratio was mostly unchanged in their latest half-year results and remains in line with the average since 2008.

The regional Australian banks' latest half-yearly profits increased slightly compared with the previous year, with modest revenue growth supported by a small further decrease in bad and doubtful debt charges. Though their profits, in aggregate, have recovered noticeably since 2009, they remain below pre-crisis levels. The slower profit recovery compared with the major banks reflects a more modest decline in the regional banks' bad and doubtful debt charges since their 2009 peak, slower asset growth and a weaker trend in net interest margins. The latest half-yearly results for the two regional banks with a larger relative exposure to Queensland were adversely affected by the natural disasters there in early 2011. However, analysts generally expect these effects to be temporary and have forecast growth in profits and a reduction in bad and doubtful debt charges for these banks in the second half of 2011.

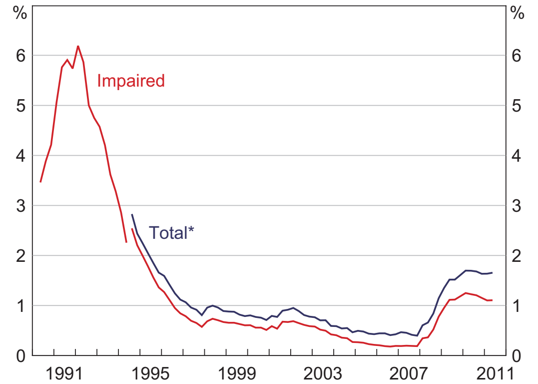
The foreign-owned banks operating in Australia recorded a further increase in their profits in the six months to December 2010, assisted by falls in bad and doubtful debt charges at the foreign bank branches. In aggregate, the foreign banks' profits are now broadly similar to the levels recorded between 2006 and mid 2008. Aggregate profits for credit unions and building societies (CUBS) have also increased steadily since late 2009 and are now above pre-crisis levels.

Asset Quality

Banks' asset performance has been broadly steady over recent quarters, with the ratio of non-performing assets to total on-balance sheet assets hovering around 1.7 per cent since early 2010 (Graph 2.4). Of this, the ratio of impaired assets – consisting

Graph 2.4
Banks' Non-performing Assets

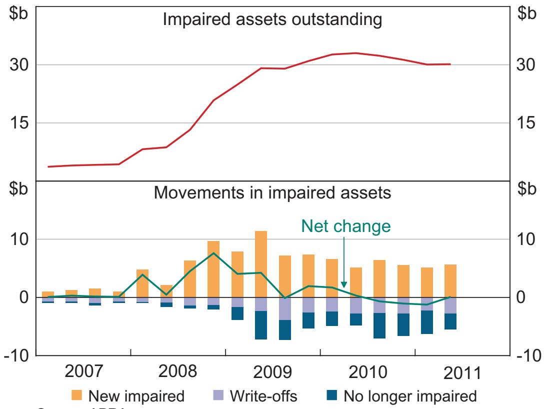
Consolidated global operations, per cent of on-balance sheet assets



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

Graph 2.5
Banks' Impaired Assets

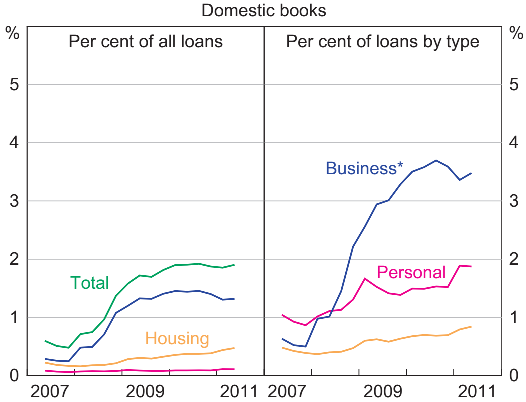
Consolidated global operations



Source: APRA

Graph 2.6
Banks' Non-performing Assets

Domestic books



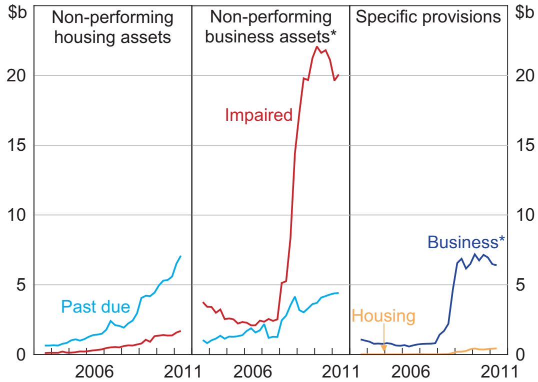
* Includes lending to financial businesses, bills and debt securities, and other non-household loans
Source: APRA

mostly of facilities that are not well-collateralised – has declined slightly to about 1.1 per cent in June, down from 1.3 per cent in March 2010. The rate at which loans have been moving out of impairment due to write-offs or 'curing' has exceeded inflows of newly impaired assets in recent quarters, causing a slight decrease in the level of impaired assets (Graph 2.5). The remaining component of non-performing assets is 'past-due' loans – those that are well covered by collateral but have repayments overdue by at least 90 days. The ratio of past-due loans to total on-balance sheet loans was 0.5 per cent in June, up from 0.4 per cent in March 2010. Even though the banks' total non-performing assets ratio remains around 80 basis points above its average over the past decade, it is still well below the early 1990s peak of over 6 per cent. It also compares favourably with the non-performing asset ratios seen in some other developed countries.

In the banks' domestic portfolio, the ratio of non-performing loans to total on-balance sheet loans has been broadly steady, at around 1.9 per cent, since September 2010 (Graph 2.6). The business loan portfolio has improved modestly, such that the non-performing share has fallen by 20 basis points to 3.5 per cent since September 2010. By contrast, the share of banks' housing loans that are non-performing has drifted up over this period, to around 0.8 per cent in June.

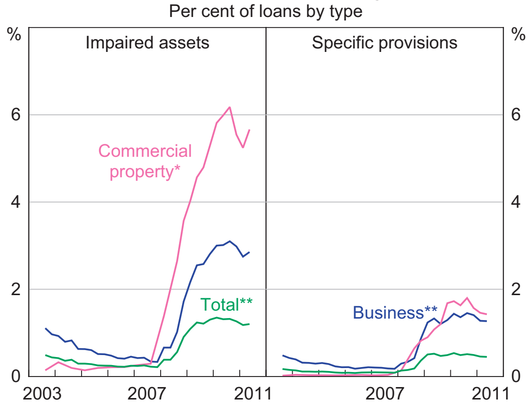
Unlike non-performing business loans, most non-performing housing loans are classified as past due rather than impaired and it is this past-due component that has increased most over the past year (Graph 2.7). As discussed further in the 'Household and Business Balance Sheets' chapter, much of the recent increase in housing arrears is due to loans that were taken out prior to 2009 when lending standards were weaker, with more recent loans tending to perform better. Because the bulk of these loans are well collateralised, and likely to remain so even if housing prices were to fall significantly, lenders' housing loan losses should remain low.

Graph 2.7
Banks' Asset Quality
Domestic books



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

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



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

A concern would arise if the extent of provisioning for these non-performing assets proved to be inadequate, which would weigh on future profit growth. In the current circumstances, it is likely that fewer cases of arrears will be resolved by the voluntary sale of the property than when housing prices were rising. As well, arrears rates in ADIs' own books may be behaving differently from the past: for example, the decline in the securitisation market may have resulted in some higher-risk borrowers who in previous years would have gone to the non-ADI sector, instead taking out loans from ADIs. The decline in the non-ADI sector also means these lenders are not refinancing as many existing ADI loans as in the past, which might otherwise have removed some loans at risk of falling into arrears from ADIs' books. Even though lending standards have tightened in the market overall as a result of these developments, individual lenders might find their own asset quality has deteriorated.

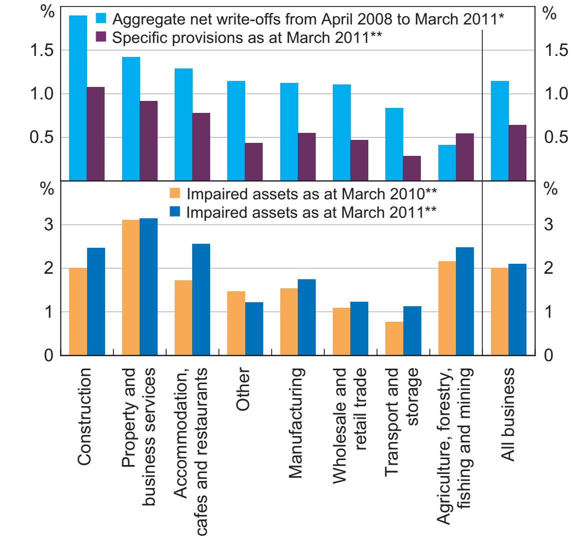
In the banks' domestic business loan portfolios, troubled commercial property exposures have been the main contributor to the high impairment rate in recent years. The share of commercial property loans that is impaired increased by about 40 basis points over the June quarter, to 5.7 per cent, although this is below its recent peak of 6.2 per cent in September 2010 (Graph 2.8). Much of the fall in impaired commercial property assets from the recent peak has been due to the liquidation of a small number of sizeable bad debts. Consistent with the sale of this debt, specific provisions held against impaired commercial property exposures have generally declined since December 2009. The impairment rate for other types of business loans has also moderated over 2011, but it is still higher than average.

More detailed data from the major banks' Basel II Pillar 3 disclosures show that business loan write-off rates since early 2008 have been above average in the construction, property and business services (incorporating commercial property), and accommodation, cafes and restaurants sectors (Graph 2.9). Impairment rates remain above average in these sectors, and are also high for the agriculture, forestry, fishing and mining industry. The relatively large increase in the impairment rate on loans to the accommodation, cafes and restaurants sector over the year to March is reportedly partly due to the difficulties of some operators of pubs, clubs and hotels.

The major banks' domestic non-performing assets ratio has been broadly steady over the past year, at about 1.7 per cent, remaining below that of the smaller Australian-owned banks and foreign-owned banks (Graph 2.10). The share of non-performing assets on the foreign banks' books has declined

Graph 2.9
Loan Losses and Asset Quality by Industry

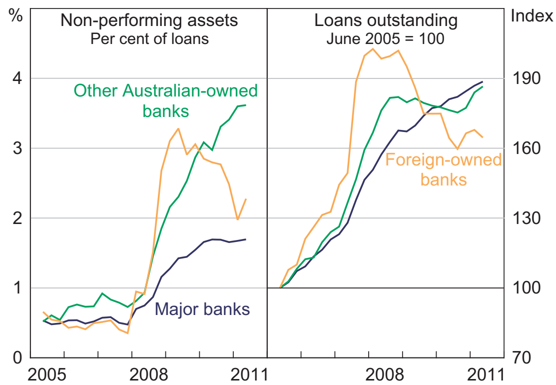
Major banks' consolidated global operations, per cent of industry exposures



* Per cent of average exposures over period; July 2008 to June 2011 for CBA
** June of each year for CBA
Source: Banks' Basel II Pillar 3 reports

Graph 2.10
Banks' Asset Quality and Loans

Domestic books



Source: APRA

from a peak of about 3.3 per cent in mid 2009 to 2.3 per cent in June 2011. By contrast, the equivalent ratio for the smaller Australian-owned banks has continued to rise over recent quarters, reaching 3.6 per cent in June 2011, despite a turnaround in loans outstanding. The deterioration in loan performance has been evident across all portfolios, though commercial property exposures continue to account for the bulk of these smaller banks' impaired assets. The non-performing share of CUBS' loans has also increased, although it remains much lower than that for the banks, partly reflecting that a larger share of CUBS' loans is to households.

The performance of the Australian-owned banks' overseas assets has continued to improve in recent quarters. Since peaking in mid 2010, the ratio of non-performing overseas assets to total on-balance sheet assets has fallen from 0.4 per cent to 0.3 per cent in June 2011, although it remains above the pre-crisis level. The Australian banks' offshore operations to date have largely been concentrated in New Zealand and, to a lesser extent, the United Kingdom. Entities in New Zealand account for around 40 per cent of Australian-owned banks' foreign exposures, arising mainly through the major banks' New Zealand-based operations. Loan performance in New Zealand has been improving recently as the economic recovery has strengthened. Asset quality at the banks' UK operations – about 20 per cent of their overseas assets – remains weaker.

Australian banks report little direct exposure to the euro area sovereigns regarded as being most at risk, and as at end March, none at all to Greek sovereign risk. Likewise, their exposures to euro area banks are low, accounting for less than 10 per cent of their total foreign claims and under 2 per cent of their total assets as at March (Table 2.2). The vast bulk of these exposures are to banks from the larger euro area countries, namely France, Germany and the Netherlands. Australian banks' exposures to banks from the countries in the euro area that have experienced the most severe fiscal difficulties are very small and have declined over the past year.

Lending Growth and Credit Conditions

Banks' domestic lending has been growing at a subdued pace in recent years, as both households and businesses remain cautious in their borrowing behaviour. Bank lending to households increased by 4.9 per cent in annualised terms over the past six months to July, down from 7.4 per cent in the six months to January 2011 (Graph 2.11). In recent

Table 2.2: Australian Bank Claims on the Euro Area[(a)]
Ultimate risk basis, as at March 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	**55.9**	**1.9**	**1.2**	**0.2**	**0.5**
of which:					
Greece, Ireland, Italy, Portugal and Spain	7.8	0.3	0.1	0.0	0.2
France, Germany and the Netherlands	44.1	1.5	1.1	0.2	0.3

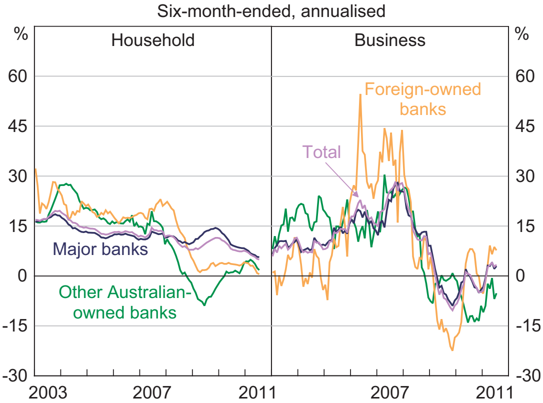
(a) Australian-owned banks and subsidiaries of foreign-owned banks; exposures include those to foreign-owned banks booked in Australia
Source: APRA

years, the foreign-owned and smaller Australian-owned banks have seen slower growth in their household lending than the major banks.

After contracting over much of the past two and a half years, bank lending to businesses expanded by 3.4 per cent in annualised terms over the six months to July, though monthly data point to it being flat in recent months. There has been some variation across institutions, with foreign-owned banks experiencing a more pronounced pick-up in their business lending, while lending by the smaller Australian-owned banks has continued to contract. There was a modest increase in bank credit to both non-financial corporations and unincorporated businesses over the first half of the year, while bank lending to financial corporations declined (Graph 2.12). Recent industry liaison indicates that demand for credit by businesses remains quite weak, mainly reflecting businesses' uncertainty about the economic outlook and subdued conditions in sectors most exposed to the strong Australian dollar and weak retail spending.

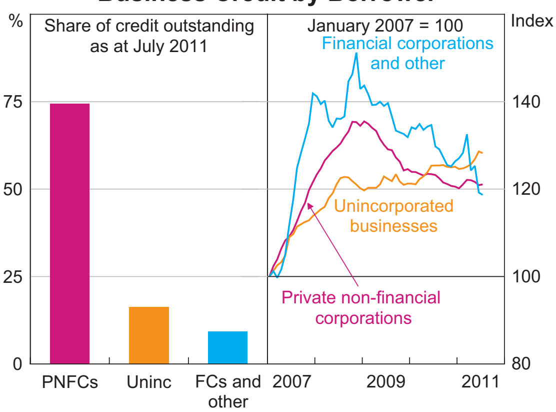
As the more cautious approach to borrowing by households and businesses is unlikely to change in the near term, lenders are having to adapt to much slower rates of credit growth than they were accustomed to in the pre-crisis period. Adapting to this environment will help avoid the risks that would be involved in trying to sustain earlier growth rates, for example by

Graph 2.11
Bank Credit Growth
Six-month-ended, annualised



Sources: APRA; RBA

Graph 2.12
Business Credit by Borrower



Sources: APRA; RBA

lowering lending standards or imprudently expanding into new products or markets.

There has been an increase in competition in the residential mortgage market in the past year. Signs of increased competition recently include higher discounts being offered on housing loans, lower fees and increases in maximum allowable loan-to-valuation ratios from 90 to 95 per cent. There has been an increase in mortgage refinancing activity in recent months as borrowers have sought better deals, exit fees have been removed or reduced and a greater volume of fixed-rate loans have matured than is typical.

However, in some other respects, lending standards remain tighter than before 2009. The share of low-doc lending has continued to fall in recent years, partly in response to the recent introduction of more stringent responsible lending guidelines that require lenders to verify a borrower's capacity to repay. Lenders also have more conservative debt-serviceability requirements than they did in earlier years, including using higher interest-rate buffers in their assessments of repayment capacity. As discussed further in the 'Household and Business Balance Sheets' chapter, recent mortgage borrowers have tended to perform better than earlier cohorts, even with the recent increases in interest rates, which is consistent with a tightening of lending standards since 2008.

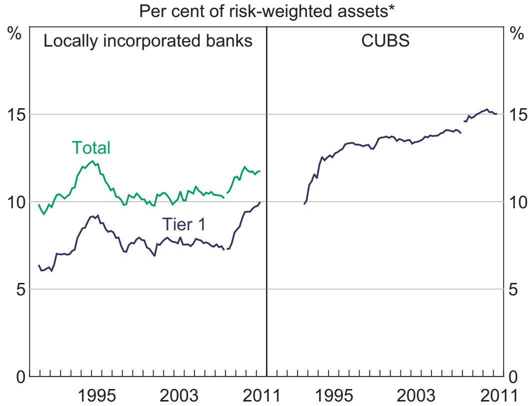
In business lending, competitive pressure to ease lending standards has generally been less intense than in the residential mortgage market. While margins have reportedly continued to narrow in the wholesale segment, margins on other business loans have been little changed over the past year.

Capital

The Australian banking system remains well capitalised, with the aggregate Tier 1 capital ratio increasing by a further 0.3 percentage points over the six months to June, to 10 per cent of risk-weighted assets (Graph 2.13). This increase was mostly due to dividend reinvestments and a sizeable proportion of earnings being retained in their latest half-yearly results; risk-weighted assets were broadly unchanged over this period. Banks have continued to run down their stocks of subordinated debt over recent years, resulting in a decline in Tier 2 capital. They have done so because these instruments in their current form will not be eligible to be included in capital under the Basel III framework after the transition period ends. Credit unions and building societies have maintained their higher capital ratios, with the aggregate Tier 1 capital ratio around 15 per cent in June.

From a longer-run perspective, the Australian banks' Tier 1 capital ratio has increased substantially since 2007 as they have responded to market pressures for banks globally to hold more capital as well as in anticipation of tougher regulatory requirements. As a result, the Australian banks are well placed to meet the new Basel III capital adequacy requirements with high-quality capital such as common equity and retained earnings. As noted in the 'Developments in the Financial System Architecture' chapter, the Australian Prudential Regulation Authority (APRA) has recently released a consultative document on how it intends to implement the Basel III framework in Australia, with a faster timetable in certain key areas than the global requirements.

Graph 2.13
Capital Ratios
Per cent of risk-weighted assets*

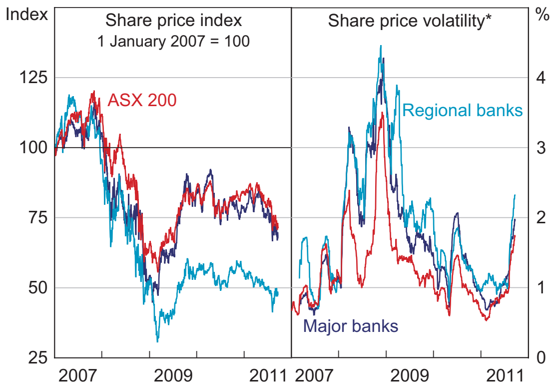


* Break in March 2008 due to the introduction of Basel II for most ADIs
Source: APRA

Financial Markets' Assessment

After a period of relative stability for much of the past year, there was a sharp increase in the volatility of Australian bank share prices in August and September associated with the turbulence in global financial markets. Bank share prices have fallen by around 10 per cent since the start of August, although there have been some sizeable swings during this period (Graph 2.14). These movements in bank share prices have generally been in line with the broader share market over this time. The increased market uncertainty during August and September was also reflected in increases in Australian banks' credit default swap (CDS) premia – the price investors pay to insure against the default on bank debt – but to a lesser extent than those of many large banks overseas.

Graph 2.14
Financial Market Indicators



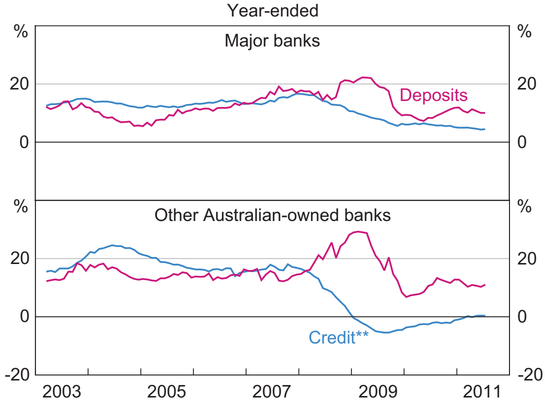
* Rolling two-month standard deviation of daily returns
Sources: Bloomberg; RBA

The major banks continue to be viewed favourably by the international credit rating agencies. A decision by Moody's to downgrade the credit ratings of the major banks by one notch in May, from Aa1 to Aa2, had minimal market impact, as it was well anticipated and only brought Moody's ratings into line with those of Standard & Poor's (S&P). Moody's decision was primarily based on its reassessment of the risks associated with these banks' offshore wholesale funding, though the agency also considered the official sector to be supportive relative to many other jurisdictions. There have also been several changes to the credit ratings of the regional banks in the past six months. S&P is still reviewing its global bank credit rating methodology and at this stage, it is expected to announce the outcome of its review later this year.

Funding Conditions and Liquidity

Overall, Australian banks have faced a favourable funding environment for much of the past year, though the latest bout of global market uncertainty has caused some tightening of wholesale funding conditions since July. Growth in deposits has remained strong over the past six months, averaging over 10 per cent on an annual basis, and continuing to exceed credit growth by a significant margin (Graph 2.15). Within this, there has been strong growth in deposits from both households and businesses, and across most types of ADIs. Underlying this growth in deposits has been an increase in the rate of household saving in recent years, some of which has flowed to the ADI sector, and robust growth in business sector profits, particularly in the resources sector. Competition in the deposit market has abated somewhat recently, especially for wholesale deposits, partly because banks are becoming more discriminating as they take into account the liquidity implications of these deposits under the Basel III liquidity rules.

Graph 2.15
Bank Credit and Deposit Growth*
Year-ended



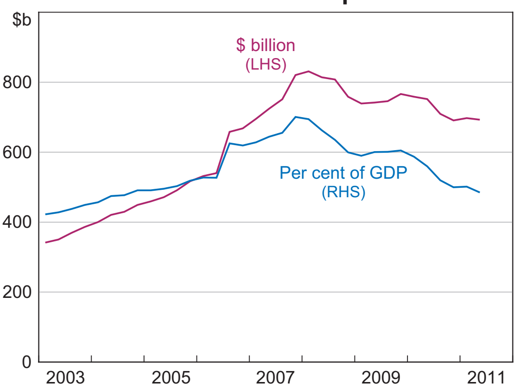
* Data are adjusted for major series breaks
** Includes securitisations
Sources: APRA; RBA

As a result of the rapid growth of deposits and subdued growth in credit over a number of years now, the difference between ADIs' loans and deposits – a measure of the funding that needs to be filled from wholesale and other sources – has declined by about one-sixth since 2008, to around $700 billion in June (Graph 2.16). Consistent with this, domestic deposits now account for about one-half of banks' funding liabilities, up from two-fifths in 2008 (Graph 2.17). As well as increasing the share of their funding from deposits, banks have also sought to lengthen the maturity of their wholesale funding over recent years in response to market and regulatory pressure. Short-term wholesale funding has fallen from about one-third of total bank funding in 2007 to around one-fifth during the past year, while the long-term wholesale funding share has risen from about one-sixth to more than one-fifth over the same period.

Banks maintained good access to domestic and offshore wholesale bond markets during the past year. Their reduced wholesale funding requirement has allowed them to take a more opportunistic approach to their bond issuance, issuing when pricing has been most attractive. Over the eight months to end August, the value of bonds issued was slightly less than matured, so the value of bonds outstanding fell (Graph 2.18). Banks also raised less wholesale funding from offshore than matured in the past year meaning that, in net terms, they have been repaying some of their foreign liabilities. While Australian banks have had limited bond issuance since July, discussions with the banks indicate that many of them are already ahead on their wholesale funding plans for the year, allowing them to hold back from issuing bonds during periods of heightened market volatility.

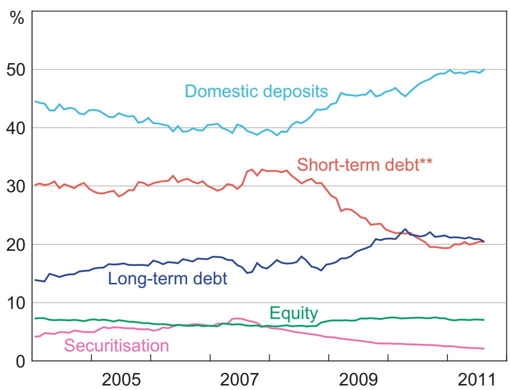
While there has been some tightening in wholesale funding conditions due to the recent global market turbulence, the overall effect has been modest compared with some other countries, and to conditions globally in 2008. Domestic secondary

Graph 2.16
ADI Credit less Deposits*



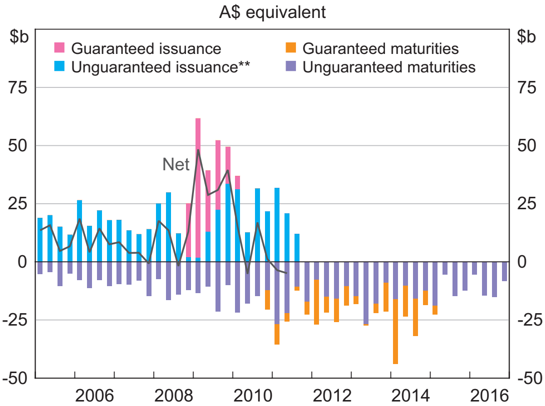
* Credit includes securitisations; deposits exclude intra-group deposits
Sources: ABS; APRA; RBA

Graph 2.17
Banks' Funding*
Per cent of total



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

Graph 2.18
Banks' Bond Issuance and Maturities*
A$ equivalent



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

market spreads on the major banks' three-year debt, for instance, have traded within a range of about 110 to 150 basis points over Commonwealth Government securities (CGS) over the past six months compared with around 200 basis points for most of 2008 (Graph 2.19).

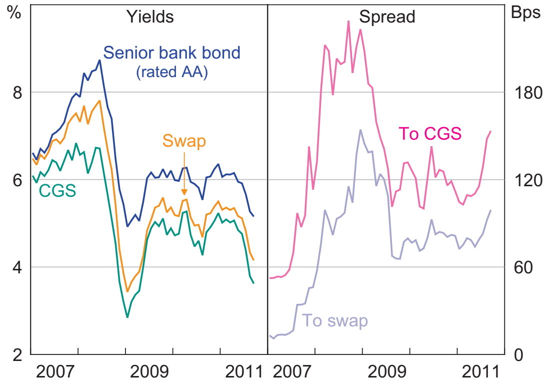
Some banks have repurchased their government-guaranteed bonds that have around one year or less left before maturity and replaced them with unsecured debt. In total, banks bought back around $13 billion of their guaranteed bonds over the past year. Many of these repurchases were securities that mature in the first quarter of 2012, a period of larger-than-average maturities of guaranteed bonds. Together with the $23 billion of guaranteed bonds that matured over the past year, repurchases have helped reduce banks' guaranteed wholesale liabilities outstanding, to around $120 billion in August, down from around $155 billion in mid 2010.

Conditions in the residential mortgage-backed securities (RMBS) market have generally improved this year. Issuance in the first half of 2011 was the strongest since 2007, with the major banks accounting for around one-half (Graph 2.20). A tightening of spreads in the secondary market has supported primary transactions and reduced the extent of support by the Australian Office of Financial Management, which only participated in around one-half of the number of transactions this year (7 per cent of the value). While there has been some issuance of commercial mortgage-backed securities this year, it remains very low compared with pre-crisis levels.

Banks have continued to increase their holdings of liquid assets, such as cash, deposits and highly marketable securities. Of this, government securities now make up a larger share than prior to the crisis, although the proportion has been stable for a couple of years. As banks have also reduced their use of short-term wholesale funding, the ratio of liquid assets to short-term wholesale liabilities has increased strongly over recent years.

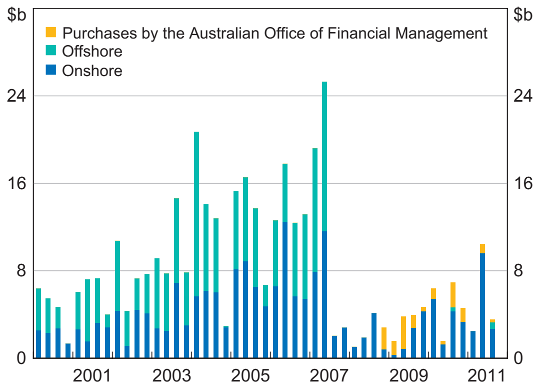
Overall, with higher capital levels and a stronger liquidity and funding position, the Australian banking system is better placed to cope with periods of market strain than it was before the crisis.

Graph 2.19
Major Banks' Bond Pricing
3-year A$ debt



Sources: Bloomberg; RBA; UBS AG, Australia Branch

Graph 2.20
Australian RMBS Issuance*
A$ equivalent, quarterly

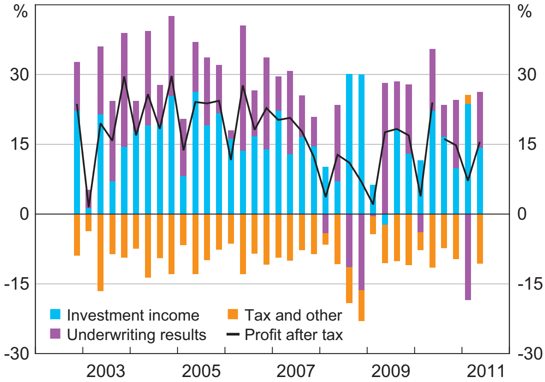


* September 2011 is quarter-to-date
Source: RBA

General Insurance

Following the natural disasters early in the year, the general insurance industry reported lower profits in the March quarter 2011, although profits have since recovered. A large underwriting loss in the March quarter was partly offset by stronger investment returns, so the annualised return on equity only dipped to 7 per cent, before returning to about 16 per cent in the June quarter on an improved underwriting result (Graph 2.21). An important factor limiting the financial impact of the disasters in the March quarter has been the insurers'

Graph 2.21
General Insurers' Performance*
Contribution to return on equity, annualised



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

reinsurance arrangements, as around three-quarters of the claims relating to the recent Australian natural disasters were covered by reinsurance with private-sector reinsurers. Australian insurers' exposure to the 2010 and 2011 Christchurch earthquakes is also significantly limited by reinsurance, particularly from the New Zealand government-owned Earthquake Commission. The estimated claims, net of reinsurance, on Australian insurers resulting from the March 2011 Japanese earthquake and tsunami were relatively small. The only Australian insurer with a notable exposure to the Japanese disasters is QBE, with estimated claims of US$137 million, net of reinsurance, mainly coming from its marine and energy insurance business lines.

As a result of the natural disasters, insurers are facing higher reinsurance costs and have started to pass these on through higher premiums, particularly on home insurance policies. Estimates of the increases in insurers' reinsurance premiums vary widely, but most are in the range of 20 to 60 per cent, which is expected to translate to an average premium increase for consumers of about 5 to 10 per cent.

The Government has established the Natural Disaster Insurance Review to examine the availability and affordability of natural disaster insurance, with a focus on flood insurance, given that many insured homes affected by the Queensland floods did not have cover for riverine flooding. The Review estimates that around 3 to 6 per cent of homes across Australia face a modest level of flood risk, and 1 per cent face a high risk of flooding. In its preliminary report, the Review has canvassed three options:

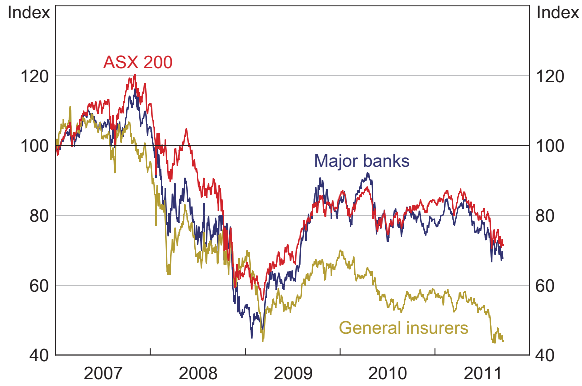
1. Automatic flood cover;
2. Automatic flood cover with the ability to 'opt out'; or
3. No change to the existing practice.

The automatic flood cover options could be accompanied by a premium subsidy for home owners in high-risk areas. The argument for a subsidy is that the premiums in high-risk areas could otherwise be prohibitively high, and some home owners may choose not to have insurance. The Review is currently considering submissions and is expected to submit its final report to the Government by the end of September 2011. In the meantime, a growing number of policies offer riverine flood cover and the Insurance Council of Australia expects this to increase to over 80 per cent of policies sold by January 2013, as additional flood mapping becomes available.

The general insurance industry coped well with the elevated level of claims and remains well capitalised, holding capital as at June 2011 equivalent to about 1.8 times APRA's minimum capital requirement. This was down from 1.9 times as at December 2010. APRA is continuing its review of general insurers' capital standards, with the aim of making them more risk-sensitive and to harmonise the capital framework for life and general insurance. The review will also more closely align the insurance capital framework with that for ADIs, where appropriate.

Insurers' strong capital levels are reflected in their high credit ratings: the Australian operations of the largest insurers are rated A+ or higher by S&P. The large Australian insurers' share prices are down by more than 20 per cent since the beginning of the year, compared with a fall of about 15 per cent for the broader market, which is similar to the movements of overseas insurers relative to broad market indices (Graph 2.22).

Graph 2.22
Share Prices
1 January 2007 = 100



Sources: Bloomberg; RBA

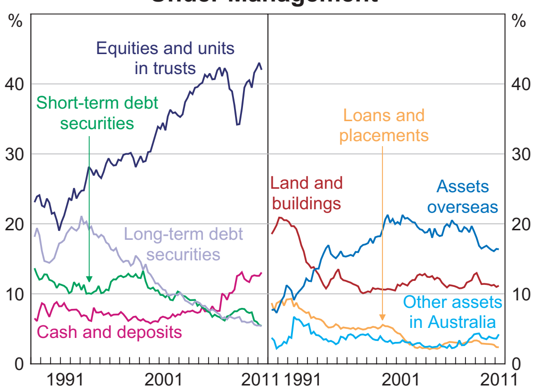
The two largest providers of lenders' mortgage insurance (LMI) in Australia, Genworth and QBE, have reported solid results in the first half of 2011. A key risk for the LMIs is the possibility of increased claims in the event that housing arrears continue to rise and housing prices remain weak. However, these two LMIs are well capitalised and both are rated AA- by S&P. The credit rating of Genworth's Australian operation has been unaffected by S&P's recent ratings downgrade of Genworth's US mortgage insurance operations, which reported a larger-than-expected loss in the June quarter 2011. In confirming Genworth Australia's rating, S&P stated that it had limited links to the troubled US operations, was soundly capitalised with robust reinsurance arrangements, and was subject to strong prudential supervision from APRA.

Managed Funds

Growth in assets held by the domestic funds management industry slowed over the June 2011 half year, with consolidated assets increasing by 4 per cent on an annualised basis in the period compared with a 9 per cent increase in the December 2010 half year (Table 2.3). Superannuation funds accounted for much of the growth in assets over the six months to June 2011. In unconsolidated terms, superannuation assets increased by almost 7 per cent on an annualised basis during the period, and superannuation funds now account for 70 per cent of managed funds' assets.

The slower asset growth in the latest half year was mainly attributable to a decline in the direct and indirect holdings of equities by superannuation funds, which were affected by the volatility in equity markets, particularly in the June quarter 2011. Funds' holdings of cash and deposits increased in the June 2011 half year, although this was partly offset by a decline in holdings of short-term debt securities (Graph 2.23). Reflecting the weaker equity market performance over the June quarter 2011, superannuation funds reported a small net investment loss of around $8 billion in the June quarter, although the overall result for the June 2011 half year was in line with the average over the past decade (Graph 2.24). Net inflows into superannuation funds remained broadly steady.

Graph 2.23
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

Life insurers' unconsolidated assets grew at an annualised rate of nearly 3 per cent in the six months to June 2011. Much of the increase was attributable to the investments of life insurers' superannuation business, which account for around 90 per cent of life insurers' assets. Life insurers reported aggregate profits in the June 2011 half year of $1.5 billion, of which 55 per cent came from

Table 2.3: Assets of Domestic Funds Management Institutions
June 2011

	Level	Share of total	Six-month-ended annualised change Dec 10	June 11
	$billion	Per cent	Per cent	Per cent
Superannuation funds	**1 299**	**70**	**15.7**	**6.6**
of which:				
Equities	377	29	33.9	3.5
Assets overseas	188	14	10.3	11.3
Units in trusts	175	13	25.1	10.3
Deposits	170	13	11.7	15.7
Net equity in life offices	164	13	10.6	-4.0
Land, buildings and equipment	74	6	7.4	10.7
Long-term securities	53	4	–10.1	3.7
Short-term securities	50	4	–8.9	–13.2
Loans and placements	10	1	10.0	–1.5
Other assets in Australia	37	3	–13.8	47.0
Life insurers[(a)]	**235**	**13**	**7.1**	**2.8**
Public unit trusts	**283**	**15**	**0.8**	**–5.6**
of which:				
Listed property trusts	125	44	4.7	–0.9
Unlisted equity trusts	98	35	6.3	–5.5
Listed equity trusts	35	12	–9.3	–17.8
Other trusts	25	9	–18.4	–9.3
Other managed funds[(b)]	**39**	**2**	**–37.7**	**–12.3**
Total (unconsolidated)	**1 856**	**100**	**10.2**	**3.6**
of which:				
Cross investments	406		15.5	1.1
Total (consolidated)	**1 449**		**8.7**	**4.4**

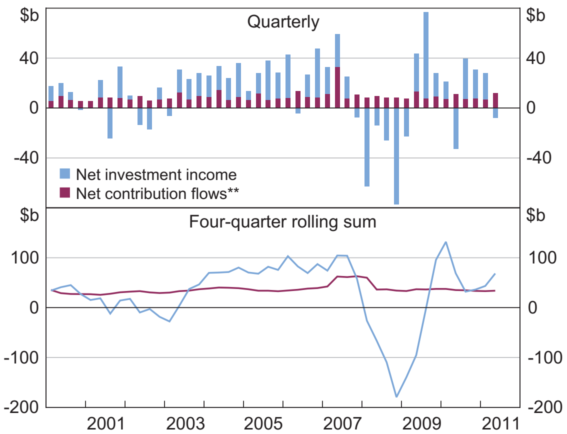
(a) Includes superannuation funds held in statutory funds of life insurers
(b) Cash management trusts, common funds and friendly societies
Sources: ABS; RBA

their superannuation business (Graph 2.25). The net premiums and net policy payments of these superannuation businesses were similar in the June 2011 half year compared with the previous half. The remainder of life insurers' profits were derived from ordinary life insurance business. Profit from this business was broadly flat when compared with the previous half year, with levels of net premiums and net policy payments remaining steady.

Life insurers remain well-capitalised, holding capital around 1.5 times their minimum capital requirements as at June 2011. As noted above, APRA is reviewing life insurers' capital standards as part of its broader review of insurers' capital standards.

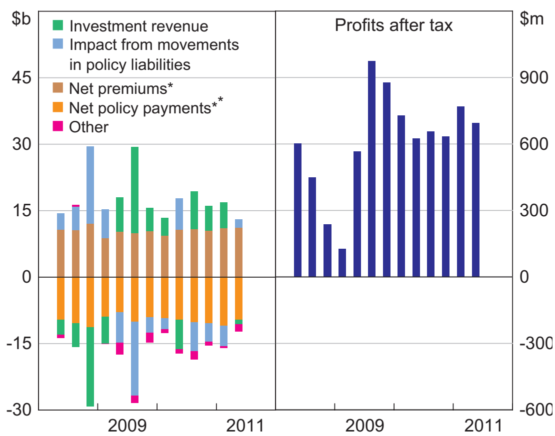
Outside of superannuation funds and life insurers, the majority of managed funds' assets are held in public unit trusts, although their share of the managed funds industry has been falling. Equity trusts experienced falls in their assets over the June half year, reflecting weaker equity markets in the second quarter. Listed property trusts had a small fall of less than 1 per cent in their asset holdings.

Graph 2.24
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 2.25
Life Insurers' Financial Performance



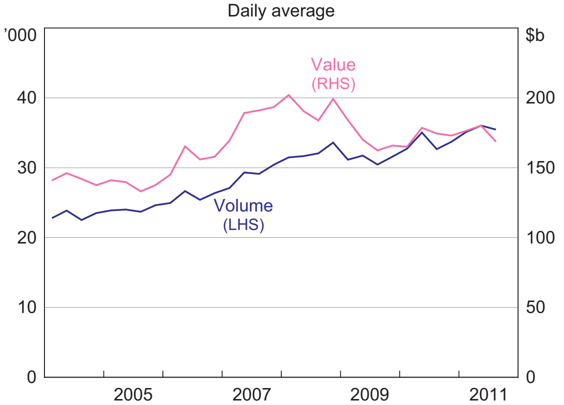
* Sum of net policy revenue, premium-related fees and net policy revenue recognised as a deposit
** Sum of net policy expenses and net policy expenses recognised as a withdrawal
Source: APRA

Market Infrastructure

Over the past six months, Australia's payments system infrastructure continued to perform well. Despite some episodes of unsettled market conditions during the period, the growth in the volume and value of high-value interbank payments and foreign exchange transactions involving the Australian dollar was broadly in line with the trends observed since the crisis. The generally low level of volatility in financial markets over the first half of 2011 was reflected in lower margins held by the central counterparties, although heightened volatility in August saw the central counterparties increase margins.

The number of transactions settled in the Reserve Bank Information and Transfer System (RITS) – where high-value payment transactions are settled on a real-time gross settlement (RTGS) basis – remained at peak levels in the first three quarters of 2011, with around 36 000 transactions settled on average each day; this is above the peak in activity before the onset of the crisis (Graph 2.26). In contrast, the average value of transactions settled in RITS fell slightly to $169 billion per day in the September quarter to date, which is about 17 per cent below the pre-crisis peak. The main impact of unsettled markets has been on values rather than volumes of RTGS activity.

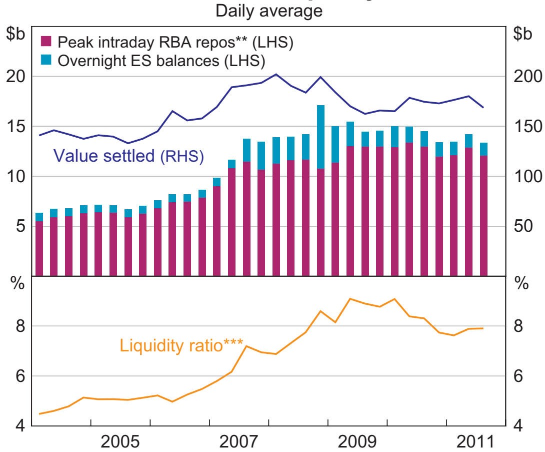
Graph 2.26
RITS Settled Payments*
Daily average



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

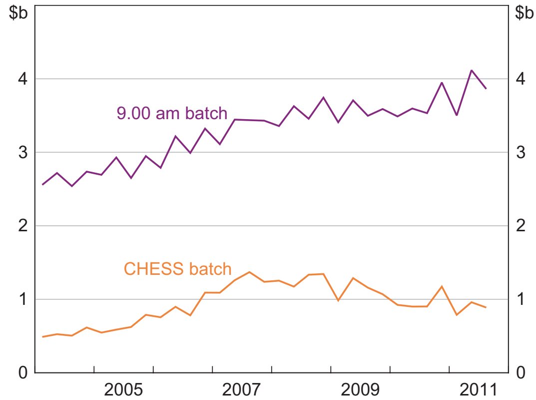
Transactions in RITS settle across Exchange Settlement (ES) accounts held at the Reserve Bank, with final and irrevocable settlement achieved by the simultaneous crediting and debiting of the ES accounts of banks and other approved institutions. Sufficient liquidity in the form of intraday ES balances is critical to ensuring that the settlement of those transactions can occur, as ES accounts are not permitted to overdraw at any time. One way to measure the amount of liquidity available to support settlement is to observe the peak in daily ES balances, calculated as the sum of overnight ES balances and the maximum level of intraday repurchase transactions (repos) undertaken with the Reserve Bank. By this measure, the amount of liquidity to support settlement peaked soon after the collapse of Lehman Brothers in September 2008 (Graph 2.27, top panel). After generally declining following the crisis, peak daily ES balances rose to $14.2 billion in the June quarter 2011, before returning in the September quarter to levels similar to the December quarter 2010. Most of the recent change in intraday ES balances has come through changes in intraday repo activity, with demand for overnight precautionary ES account balances continuing its steady decline from the peak levels seen during the crisis. The liquidity ratio, measured as peak daily liquidity over settled value, approached 8 per cent in the September quarter to date (Graph 2.27, bottom panel). This measure of liquidity remains reasonably high compared with its historical average.

Graph 2.27
RITS Peak Liquidity*
Daily average



* September 2011 is quarter-to-date
** Maximum intraday cumulative balance of first-leg RBA repos less second-leg RBA repos
*** Peak liquidity as share of value settled
Source: RBA

Graph 2.28
RITS Batch Settlement*
Daily average

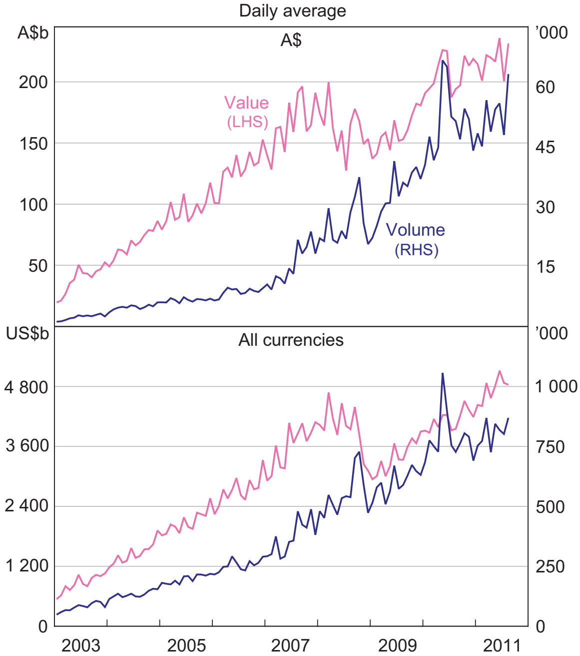


* September 2011 is quarter-to-date
Source: RBA

RITS also settles batches of net interbank obligations. The 9.00 am batch includes the settlement of low-value retail payments, such as cheques, debit and credit card transactions, and direct entry. In the June quarter 2011, the average daily value settled in the 9.00 am batch increased to a new peak of $4.1 billion, up 18 per cent compared with the previous quarter (Graph 2.28). This included the largest daily 9.00 am batch since October 2008, with a settled value of $9.4 billion, on Wednesday, 27 April – the first settlement day after the 5-day Easter/Anzac Day public holiday period. These 9.00 am batch values have remained high in the September quarter. The average daily value settled in the ASX's CHESS (Clearing House Electronic Sub-register System) batch – which settles payment obligations arising from equities transactions – fell in the September quarter to date, after increasing by 22 per cent in the June quarter 2011. The values settled in the CHESS batch remain well below their pre-crisis levels and reflect the 'lumpiness' of capital raising activity, together with fluctuations in equities market turnover.

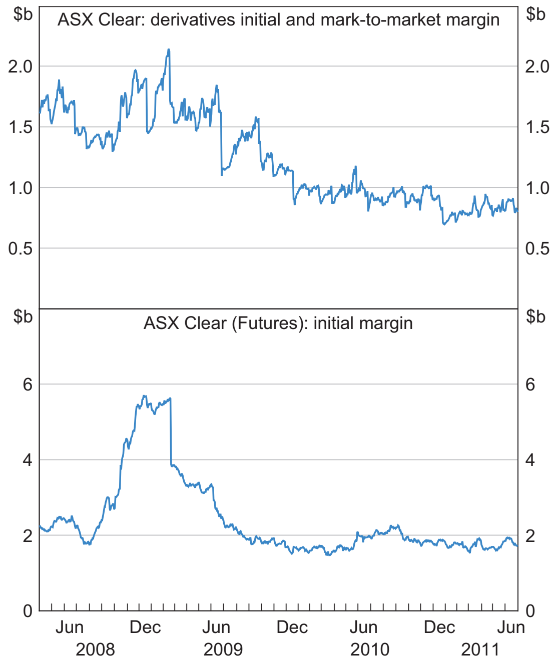
Continuous Linked Settlement (CLS) Bank settles foreign exchange transactions on a payment-versus-payment basis, thereby eliminating foreign exchange settlement risk. It settled an average of $218 billion of foreign exchange transactions

Graph 2.29
CLS Settlement



Source: CLS Bank

Graph 2.30
Margins



Source: ASX

involving the Australian dollar each day in 2011 to August (Graph 2.29, top panel), around $13 billion more than the average settled each day in the second half of 2010. This is in line with the trend of strong growth in the value of settlements across all currencies since the crisis (Graph 2.29, bottom panel).

Two central counterparties, ASX Clear and ASX Clear (Futures), are operated by the Australian Securities Exchange and play a critical role in Australia's financial markets. Through a process known as novation, these entities interpose themselves between trades – effectively becoming the buyer to every seller and seller to every buyer – on Australia's major equities and derivatives markets. While this reduces risk arising from bilateral exposures between participants, it also leads to the concentration of risks within the central counterparties, which they manage through a range of risk controls.

ASX Clear and ASX Clear (Futures) are overseen by the Australian Securities and Investments Commission (ASIC) and the Reserve Bank. ASIC has responsibility for ensuring that central counterparties licensed under the *Corporations Act 2001* meet their obligations under the Act. The Reserve Bank has responsibility for ensuring that licensed central counterparties conduct their affairs in a way that is consistent with financial system stability. To this end, the Reserve Bank conducts an annual assessment of each central counterparty's compliance with the Reserve Bank's *Financial Stability Standard for Central Counterparties*.

A key risk control employed by the central counterparties is the collection of margin on derivatives positions. Despite derivatives trading growing in the first half of 2011 compared with the second half of 2010, the margin held against these positions fell slightly (Graph 2.30). This partly reflected the lower level of volatility in market prices in the period as a whole, even though volatility of equities prices increased following the Japanese earthquake and tsunami in March. The more recent spike in volatility since early August led to increases in the number of intraday margin calls made by the central counterparties and the initial margin rates on many derivatives contracts.