Submission to the Inquiry into the Post-Global Financial Crisis Banking Sector

Senate Economics References Committee

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Contents

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Overview

This submission outlines recent developments in the banking sector. It builds on a number of submissions by the Reserve Bank to recent Parliamentary inquiries on similar issues and the analysis in the Reserve Bank's regular publications, including the semi-annual *Financial Stability Review* and quarterly *Statement on Monetary Policy*.

The main conclusions are:

- Credit remains available to most borrowers, although on terms which are somewhat tighter than the period immediately prior to the crisis. The one sector where the availability of credit is noticeably more constrained is commercial property. This reflects a combination of factors, including an increase in non-performing loans, the exit of some foreign-owned credit providers, and a lack of appetite by the remaining lenders to increase their exposures to this sector.
- Since the onset of the global financial crisis in 2007, there has been a lift in the whole structure of interest rates in the economy relative to the cash rate. This has reflected higher wholesale credit spreads and increased interest rates on deposits due to increased competition. Higher funding costs for financial intermediaries have led to higher loan rates relative to the cash rate. This realignment of funding costs and lending rates, relative to the cash rate, has occurred at various stages over the past five years. While funding costs and lending rates had largely stabilised relative to the cash rate by the end of 2010, over the past year there has been a further increase in both funding costs and lending rates relative to the cash rate.
- Australian banks continue to record strong profits, although the growth rate of these profits has slowed. Banks' returns on equity remain similar to those of other major companies in Australia as well as those of banks in other countries prior to the global financial crisis.

Trends in Bank Lending

Over the 25 years prior to the onset of the global financial crisis, credit grew at about three times the pace of nominal GDP, increasing from around 50 per cent of GDP in the mid 1980s to around 160 per cent by the beginning of the crisis in mid 2007 (Graph 1). This mainly reflected the increased capacity of borrowers, especially households, to service debt as nominal interest rates fell in line with the decline in inflation since the early 1990s. Financial deregulation, increased competition, new products, and some easing in lending standards were also factors.[1]

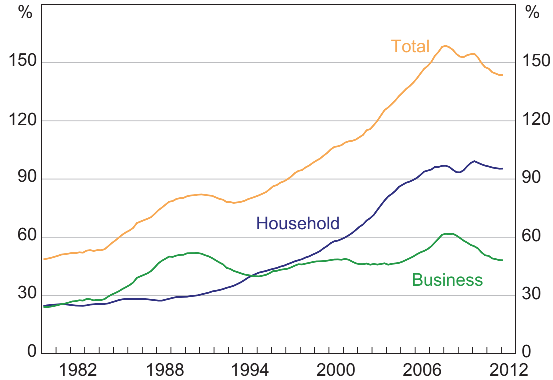
Since the onset of the global financial crisis credit growth has slowed. Over the past year credit has grown by just over 3½ per cent, which is around 2½ percentage points lower than growth in nominal GDP (Graph 2). While this is considerably slower than before the global financial crisis, the current pace of household lending growth is similar to income growth. Notwithstanding the recent pick-up in business lending, households' and businesses' attitude towards debt are unlikely to change in the foreseeable future.

In housing lending markets, the major banks have been competing for most of the past year for market share in an environment of slower credit growth. Most of this competition has been in the form of larger discounts. Non-price conditions for housing lending have been eased only very slightly over recent years. Our assessment is that lending standards remain marginally tighter than before the crisis.[2] The share of low-doc

1 See Reserve Bank of Australia (2010), 'Submission to the Inquiry into Competition within the Australian Banking Sector', Submission to the Senate Economics References Committee Inquiry into Competition within the Australian Banking Sector, 30 November.

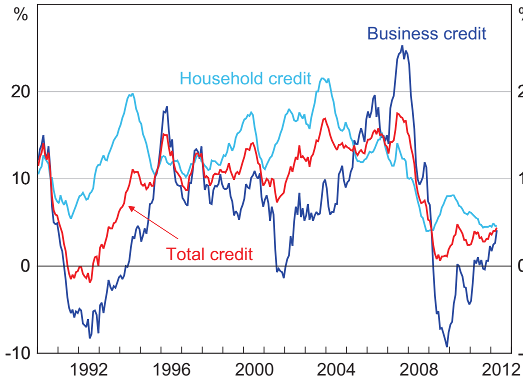
2 See Reserve Bank of Australia (2011), 'The Australian Financial System', *Financial Stability Review*, September, p 34.

Graph 1
Credit
Per cent of nominal GDP



Sources: ABS; RBA

Graph 2
Credit by Sector
6-month annualised



Sources: APRA; RBA

lending has fallen since the middle of the previous decade, and is now just over 1 per cent of banks' loan approvals. The decline was partly in response to the introduction of national responsible lending guidelines that require lenders to verify a borrower's capacity to repay. Non-conforming lending remains a negligible share of outstanding lending and, at present, the flow of new lending is insignificant.

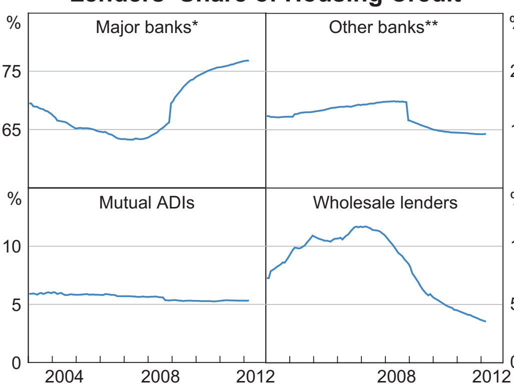
Since early 2012, competition among the major banks in terms of pricing has eased somewhat, partly reflecting the higher funding costs relative to the cash rate (discussed below). This has contributed to the major banks' market share of approvals for new housing loans declining slightly since early 2012 (although their share of the existing stock of housing credit has risen) (Graph 3 and Graph 4).[3]

Conditions in securitisation markets improved during 2011, with issuance for the year the highest since 2007. However, these markets were affected by the heightened risk aversion related to events in Europe in the

Graph 3
Major Banks' Housing Loan Approvals*
Share of total value, seasonally adjusted

* Includes Bankwest from December 2008
Sources: ABS; APRA; RBA

Graph 4
Lenders' Share of Housing Credit



* Includes Bankwest from December 2008
** Excludes mutual banks
Sources: ABS; APRA; RBA

3 See Reserve Bank of Australia (2010), 'Submission to the Inquiry into Competition within the Australian Banking Sector', Submission to the Senate Economics References Committee Inquiry into Competition within the Australian Banking Sector, 30 November.

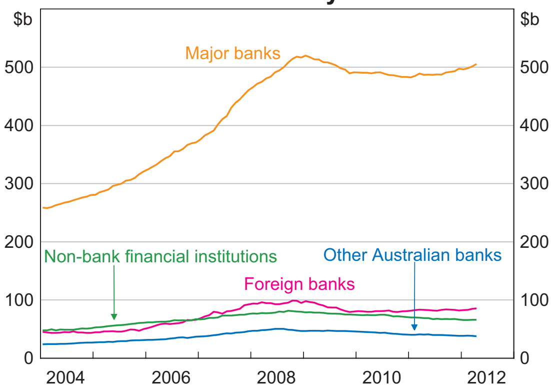
second half of 2011. Much of the issuance in 2011 was undertaken by the major banks, including some covered bond issuance.[4] In contrast, so far this year there have been five RMBS transactions, only one of which was by a major bank.

The structure of the market for business credit has changed somewhat since the global financial crisis. Some foreign lenders (banks and non-banks) have exited, particularly European-owned entities, as their parent entities have sought to scale back their global operations. The overall level of business credit provided by foreign-owned entities has, however, been little changed over the past year, with a number of Asian banks expanding their local presence (Graph 5).[5]

The most significant change in business lending since the onset of the global financial crisis has been in the provision of finance to the commercial property sector, including developers of residential property. Some of this reflects the fact that the foreign banks which have scaled back their operations in Australia had large exposures to this sector. Other banks have also reassessed the risks of lending to this sector, in light of commercial property exposures accounting for a disproportionate share of impaired bank loans.

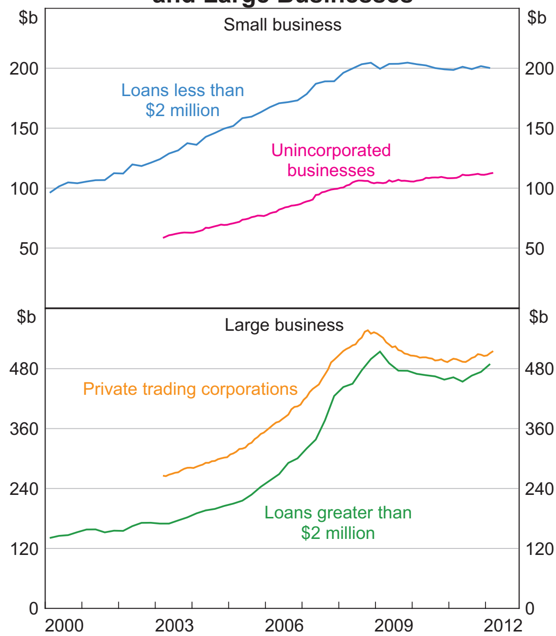
Beyond developments in commercial property, the softness in business credit in the years following the global financial crisis has reflected both weak demand from the non-mining business sector as it has taken a more conservative approach towards debt in an uncertain environment, and the mining sector making little use of domestic intermediated credit. More recently, there are some tentative signs that larger business borrowers are willing to take on some additional debt (Graph 6).

Graph 5
Business Credit by Source



Sources: APRA; RBA

Graph 6
Bank Lending to Small and Large Businesses



Sources: ABS; APRA; Austraclear; RBA

4 See Reserve Bank of Australia (2012), 'Box D: Covered Bond Issuance by Australian Banks', *Statement on Monetary Policy*, February, pp 57–58.

5 See Reserve Bank of Australia (2012), 'Foreign-owned Bank Activity in Australia', *Financial Stability Review*, March, pp 38–40.

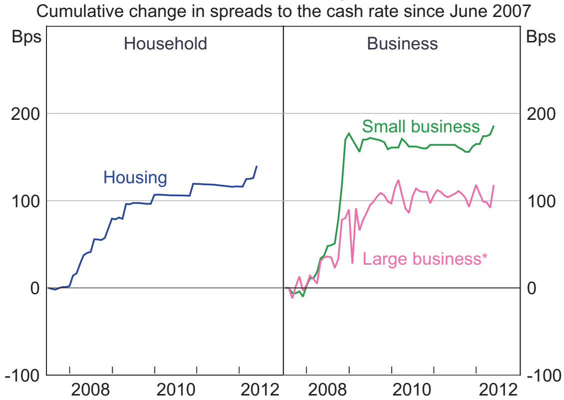
Lending Rates

The spread between lending rates and the cash rate has increased by about 25 basis points over the past 12 months, which is in addition to the 130 basis points or so increase over the previous four years. The increases reflect efforts by banks to retain their net interest margins in the face of a combination of higher funding costs relative to the cash rate (discussed below), a shift in the composition of funding towards higher-cost forms, including equity, and an increase in expected loan losses.[6] The forthcoming implementation of the Basel capital and liquidity standards is likely to have only a marginal effect on lending rates relative to the cash rate.[7]

The increases in lending rates have varied across the different types of loans, reflecting factors such as changes in expected losses in light of recent experience and the speed at which loans can be repriced (Graph 7). A combination of these factors has meant that rates charged on small business loans, for instance, have increased the most. Even for similar products, there has been a marked increase in the range of interest rates offered by banks.

As stated on a number of occasions, the Reserve Bank Board has taken these developments into account in its setting of the cash rate, to ensure that the lending rates faced by bank customers are consistent with the desired stance of monetary policy.[8]

Graph 7
Variable Lending Rates
Cumulative change in spreads to the cash rate since June 2007



* Loans greater than $2 million; includes bill lending
Sources: ABS; APRA; Perpetual; RBA

Trends in Banks' Funding

The level of the cash rate set by the Reserve Bank is a primary determinant of the level of intermediaries' funding costs and hence the level of lending rates.[9] It is the short-term interest rate benchmark that anchors the broader interest rate structure for the domestic financial system. However, there are other significant influences on intermediaries' funding costs, such as risk premia and competitive pressures, which are not affected by the cash rate. At various points in time, changes in these factors can result in changes in funding costs that are not the result of movements in the cash rate. Changes in the composition of banks' funding have

6 For more detail on the effects of equity funding and expected losses, see Fabbro D and M Hack (2011), 'The Effects of Funding Costs and Risk on Banks' Lending Rates', RBA *Bulletin*, March, pp 35–41.

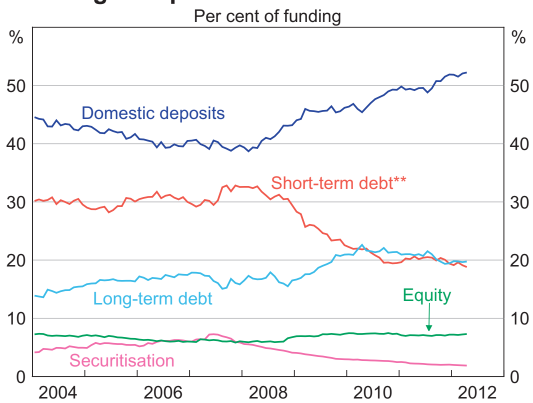
7 For estimates, see Littrell C (2011), 'APRA's Basel III Implementation: Rationale and Impacts', speech at the APRA Finsia Workshop, Sydney, 23 November.

8 See Debelle G (2012), 'Bank Funding', address to the Australian DCM Summit 2012, Sydney, 22 March.

9 See Debelle G (2012), 'Bank Funding', address to the Australian DCM Summit 2012, Sydney, 22 March.

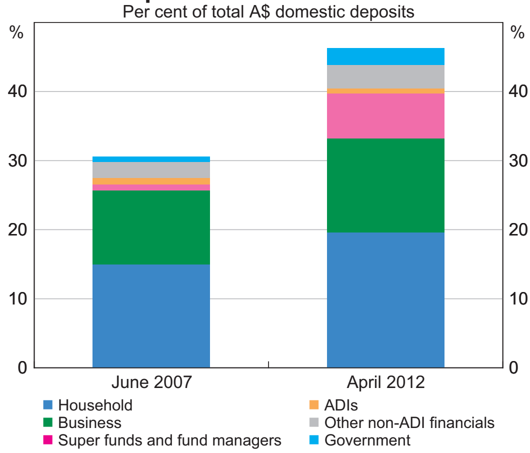
also played an important role. For example, competition for deposit funding, particularly term deposits, has increased considerably over the past couple of years as banks have sought to make greater use of more stable funding sources. This has increased deposit rates relative to the cash rate and contributed to a marked change in the composition of bank funding (Graph 8 and Graph 9).[10]

Graph 8
Funding Composition of Banks in Australia*



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

Graph 9
Term Deposits with Banks in Australia



Source: APRA

While deposit rates and yields on bank debt generally declined between mid 2011 and early 2012, the declines have not matched the reduction in the cash rate.[11] Indeed, the cost of new term deposits has increased quite considerably relative to market benchmarks. As a result, there has been an increase in the weighted-average cost of funds for bank relative to the cash rate. This increase in funding costs, relative to the cash rate, is in addition to the increase that occurred between mid 2007 and 2010. Given the interest of banks in stable funding sources, the cost of this funding source is likely to stay elevated relative to the cash rate.

While spreads on new wholesale debt have declined so far this year, banks' funding costs are about 50 basis points higher than they were in mid 2011 relative to the cash rate. In part, this reflects banks gradually rolling over their maturing long-term funding at higher spreads. Term deposit costs relative to benchmark rates are also high relative to history, at both short and long maturities.[12]

Overall, the RBA estimates that the major banks' costs of funding their aggregate loan books has increased by about 140–150 basis points, relative to the cash rate, since mid 2007. The available evidence suggests that, in aggregate, the increase in the regional banks' funding costs since the onset of the financial crisis has been larger than that experienced by the major banks. This reflects the fact that smaller banks have experienced a larger increase in funding costs and have made a larger shift in their funding mix towards deposits.

Margins

Most of the major banks reported a narrowing in their net interest margins over the first half of their 2012 financial years. Since the onset of the crisis the net interest margin of the major banks has fluctuated between

10 See Edey M (2010), 'Competition in the Deposit Market', speech at the Australian Retail Deposits Conference 2010, Sydney, 19 May.

11 See Deans C and C Stewart (2012), 'Banks' Funding Costs and Lending Rates', RBA *Bulletin*, March, pp 37–43.

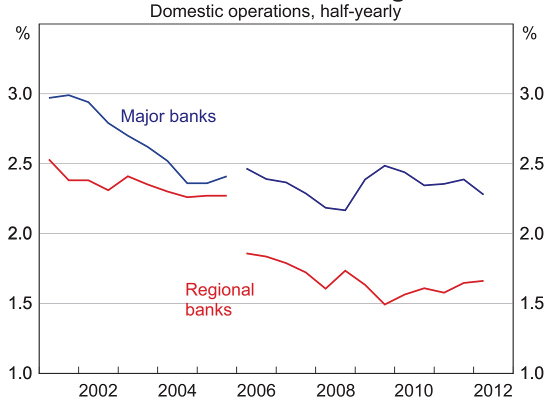
12 See Reserve Bank of Australia (2012), 'Domestic Financial Markets', *Statement on Monetary Policy*, May, pp 51–53.

2¼ and 2½ per cent (Graph 10). Changes in lending rates and funding costs since the end of the major banks' most recent half years are likely to keep margins around this range.

The net interest margin of the regional banks has declined since the onset of the crisis, mainly reflecting the larger increase in funding costs, but has increased for some regional banks over the past year. Overall, since mid 2007, the regional banks' net interest margins have fallen by between 10 and 15 basis points.

While lending rates and funding costs are important determinants of banks' net interest margins, banks' net interest margins are also influenced by a number of other factors, such as the use of derivatives to hedge interest rate risk on assets and liabilities and the size of banks' equity buffers. The contribution of these factors varies from year to year.

Graph 10
Banks' Net Interest Margin*
Domestic operations, half-yearly



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

Fees

The financial crisis has had two opposing effects on banks' fee income.[13] First, heightened competition for deposit funding has seen banks reduce and remove exception fees on deposit and transaction accounts for both businesses and personal customers. On the other hand, the repricing of credit and liquidity risk on loans and bank bill facilities has resulted in an increase in fees, particularly on undrawn loan facilities held by businesses. The net effect of these changes has been a decline in the ratio of fee income to assets, from 0.7 per cent in mid 2007 to 0.5 per cent in mid 2010. (The ratio peaked in 2001 at 0.9 per cent.) The results of the most recent survey, for banks' 2011 financial years, will be published in the June Reserve Bank *Bulletin*. Preliminary results suggest that these trends have continued.

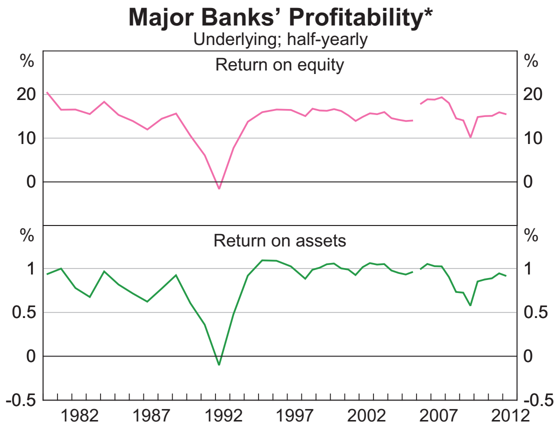
Profits

The major banks' return on assets has averaged around 0.9 per cent and the post-tax return on equity has averaged about 15 per cent since 1992 (Graph 11). Banks' returns on equity are similar to those of other major companies in Australia as well as those of banks in other countries prior to the global financial crisis. Australian banks' better performance than overseas banks in the period since the onset of the crisis largely

13 See Reserve Bank of Australia (2011), 'Banking Fees in Australia', *Bulletin*, June, pp 23–27 and Reserve Bank of Australia (2010), 'Submission to the Inquiry into Competition within the Australian Banking Sector', Submission to the Senate Economics References Committee Inquiry into Competition within the Australian Banking Sector, 30 November.

reflects Australian banks' better bad and doubtful debt experience.[14] Future profitability growth is likely to be constrained given the significant slowing in credit growth. Banks will have to be careful in how they respond to this as boosting profitability through cost cutting or overseas expansions is not without its risks.[15]

Graph 11



* Excluding abnormal items; in 2006 the banks began reporting on an AIFRS rather than an AGAAP accounting basis; data prior to 1998 are on a yearly basis

Sources: RBA; banks' annual and interim reports

Other Developments

Committed Liquidity Facility

As part of the implementation of the Basel III liquidity reforms in Australia, banking institutions are required to hold sufficient high-quality liquid assets to survive an acute stress scenario lasting one month. Under the new liquidity coverage ratio (LCR) requirement, the Basel standard prescribed that high-quality liquid assets will take the form of government securities. However, in Australia, the supply of government securities is limited. The committed liquidity facility (CLF) is designed to meet the shortfall between Australian banks' holdings of government securities and their liquidity requirements. To secure the Reserve Bank's commitment, banks will be required to pay a market-based fee of 15 basis points per annum against the size of the facility.[16]

Financial Claims Scheme

The Financial Claims Scheme (FCS) is a form of deposit insurance that provides depositors with certainty that they will recover their deposits in a timely fashion in the event that an Australian authorised deposit-taking institution fails. The FCS was introduced in 2008, at the height of the global financial crisis. Initially, deposit coverage of up to $1 million per depositor was provided free by the government (with additional coverage available for a fee). Coverage under the FCS was reduced from $1 million to $250 000 per depositor from 1 February 2012. The reduction in the cap has not had any discernable impact on deposit flows and is estimated to cover around 80 per cent of household deposits by value.[17]

14 See Edey M (2011), 'Remarks to the Property Council of Australia', Property Council Congress 2011, Darwin, 25 July.

15 See Reserve Bank of Australia (2012), 'The Australian Financial System', *Financial Stability Review*, March, p 21.

16 For further information on the CLF, see Reserve Bank of Australia (2011), 'The RBA Committed Liquidity Facility', Media Release No 2011-25, 16 November and Debelle G (2011), 'The Committed Liquidity Facility', speech at the APRA Basel III Implementation Workshop 2011, 23 November.

17 See Reserve Bank of Australia (2012), 'Developments in the Financial System Architecture', *Financial Stability Review*, March, p 64 and Turner G (2011), 'Depositor Protection in Australia', RBA *Bulletin*, December, pp 45–55.