FINANCIAL STABILITY REVIEW

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Overview

Conditions in the global financial system have improved significantly since the time of the last *Financial Stability Review* in March. While markets remain under a degree of stress, the extreme risk aversion that broke out following the Lehman Brothers collapse last September has dissipated, and confidence has begun to recover. These developments have occurred alongside signs of improved prospects for recovery in the global economy.

The period of most intense stress in global markets extended over the six months from September 2008 to March 2009. This period was marked by steep declines in world equity prices, exceptionally large risk premiums in a range of markets and serious dysfunction in wholesale credit markets. It was during this period that governments around the world moved to support their financial systems by expanding depositor protection and offering guarantees for banks' wholesale funding.

The improvement in financial conditions since March has been evident across a range of indicators. Equity prices in the major economies have reversed some of their earlier declines, rising by around 50 per cent from their trough. Credit spreads have narrowed and, in recent months, there has been a resumption of activity in unguaranteed credit markets that had previously been closed. Another encouraging sign is that most major banks in the United States and Europe have reported profits recently after the large losses incurred during 2008.

Notwithstanding these more positive developments, the situation in the global financial system remains challenging. In particular, loan losses associated with banks' on-balance sheet lending still have some way to unfold, with commercial property an area of particular weakness in some countries. In addition, the transition away from emergency support measures and towards more normal macroeconomic policy settings still has to be managed.

The Australian financial system has, throughout the crisis period, remained resilient. In aggregate, the Australian banks have experienced only a modest decline in profitability. While there has been some diversity of performance across banks, increases in loan losses and impairments across the banking system to date have been lower than in many other countries. The banks are well capitalised and have strengthened their balance sheets further with significant new equity raisings during the past year.

The Australian banks and other authorised deposit-taking institutions (ADIs) were affected by the financial crisis primarily through its impact on the cost and availability of funding. Wholesale borrowing costs increased significantly relative to the cash rate, and in some cases funding markets were effectively closed. The introduction of the guarantee arrangements late last year played an important part in ensuring that Australian banks and other ADIs maintained access to funding during the most intense phase of the crisis, and that the system was therefore able to continue lending.

More recently, conditions in funding markets for Australian institutions have been improving. As has been occurring in global markets generally, risk spreads faced by Australian wholesale borrowers have declined over recent months. With investor risk appetite returning, the higher-rated banks have been increasingly willing to tap wholesale markets on their own credit standing, without the support of the Government guarantee. Spreads on residential mortgage-backed securities in the Australian market have also narrowed, and this has begun to support new issuance to private investors.

In the non-financial sectors, sentiment among Australian households and businesses has improved considerably over recent months, as it has in other countries. The household sector experienced a sharp decline in net worth during the period when equity prices were falling, but this has been partly reversed since March, and household disposable income has received a significant boost from interest rate reductions and fiscal transfers. Overall borrowing by households has continued to expand over the past couple of years, though the pace of growth has moderated. Margin lending to households has declined sharply, and there has been little growth in other forms of personal lending or in lending for investment housing. However, lending for owner-occupied housing has picked up noticeably since the start of the year in an environment of low interest rates, first-home owner incentives and improving confidence. The increase in borrowing has been associated with firmer conditions in the market for established housing.

In contrast to developments in the household sector, borrowing by businesses from financial institutions has been declining since late last year. This has reflected both reduced demand for credit in the current environment and, to some extent, tighter lending standards. While most businesses entered the crisis period with sound balance sheets after a long period of economic expansion, the climate of uncertainty over the past year has prompted many of them to strengthen their balance sheets, by taking advantage of the recovery in equity markets to raise additional equity.

In summary, global financial conditions remain challenging. But, while further setbacks cannot be ruled out, the severe downside risks that loomed six months ago have significantly abated. The resilience of the Australian financial system through the crisis period has reflected a combination of factors including the comparatively mild nature of the overall economic slowdown in Australia, the absence of large-scale exposures to structured securities, and relatively conservative lending practices, particularly for housing. While loan losses may rise further in the current environment, Australian banks remain better placed than their counterparts in many other advanced economies to weather any further adverse developments in the global financial system.

As foreshadowed in the March *Review*, substantial work is underway around the world to reconsider financial regulations in light of the lessons from the financial crisis. Much of this work is being co-ordinated through major international forums including the G-20, the Financial Stability Board and the Basel Committee on Banking Supervision. Key areas of focus include capital and liquidity standards, systemic risk, compensation and incentives, and accounting standards. Australia is an active participant in these discussions, and the Reserve Bank will be working closely with other domestic authorities to consider Australia's response to these international regulatory developments.

The Global Financial Environment

Conditions facing the global financial system have improved markedly over the past six months. The extreme risk aversion prevailing in the wake of the failure of Lehman Brothers has eased, and investors have become more confident that the earlier feared worst-case scenarios have been avoided. The turnaround in financial market sentiment has relieved some of the pressure on asset valuations and financing activity evident during the period of extreme pessimism, and has contributed to increased confidence more broadly.

An important catalyst for the improvement in sentiment since March has been the run of stronger macroeconomic data, particularly in the Asian region, as fiscal and monetary stimulus have taken hold. Also influential is that a number of large international banks have, after sustaining heavy losses in 2008, returned to profitability and undertaken successful private capital raisings. Earlier steps taken by authorities to bolster the funding and, in some cases, capital position of the financial sector have also been supportive. The outlook nonetheless remains challenging: macroeconomic conditions continue to weigh on loan quality, lending conditions remain tight and confidence is potentially fragile. A particular issue is how the emergency official actions to stimulate economies and support financial sectors will be unwound and how this might affect financial institutions and markets.

Profitability and Capital

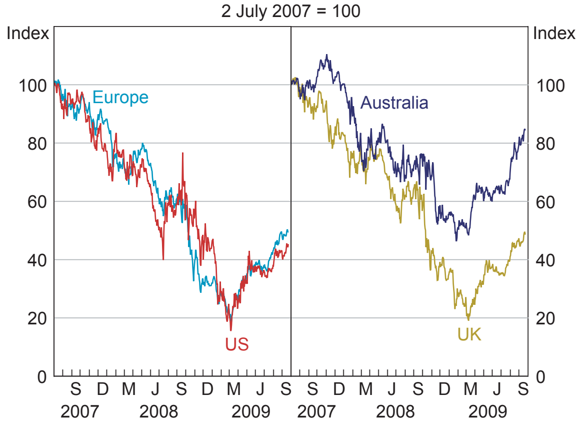
Financial market data clearly show the improvement in confidence in the global financial system. Since the trough in March, bank share price indices in the United States, Europe and the United Kingdom have recovered around one third of the fall over the preceding 18 months (Graph 1). Similarly, credit default swap (CDS) premiums have fallen sharply over the period, and have generally returned to around the levels prevailing prior to the collapse of Lehman Brothers (Graph 2).

The improved profit performance of banks has supported this recovery in sentiment. After a significant deterioration in performance in 2008, including large losses at some banks, the global banking system as a whole has returned to profitability in 2009, which has helped rebuild capital and reduce leverage (Graph 3). Both the fall and the subsequent turnaround in profitability have been broad based. In the United States, Federal Deposit Insurance Corporation (FDIC) insured institutions collectively

Graph 1

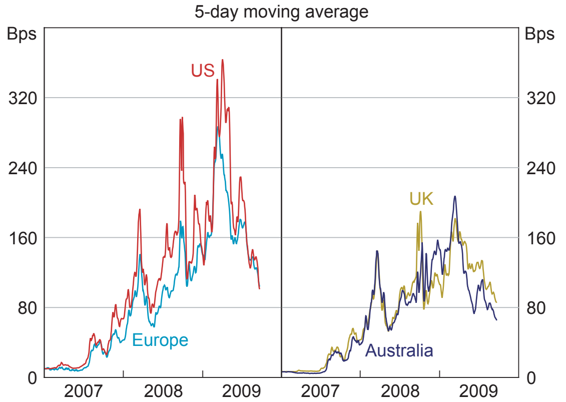
Banks' Share Prices

2 July 2007 = 100



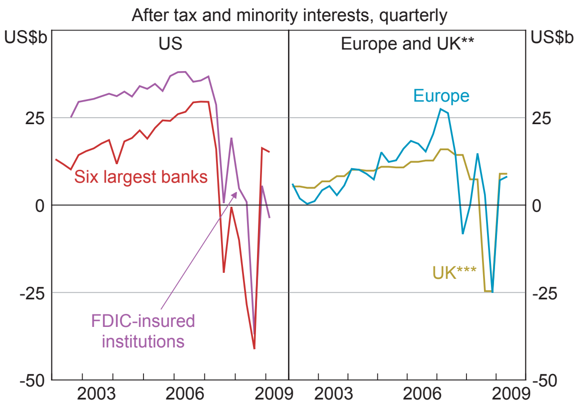
Source: Bloomberg

Graph 2
Banks' Senior 5-year CDS Premiums



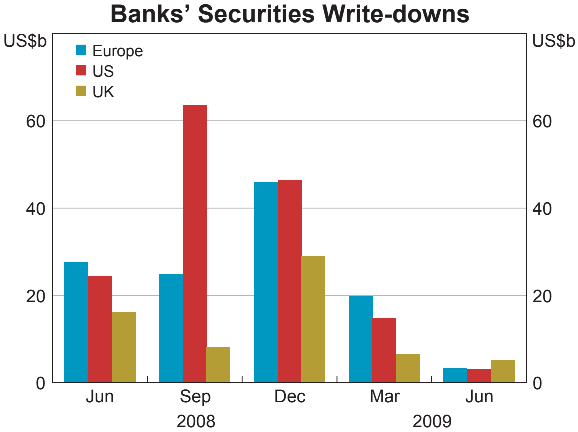
Sources: Bloomberg; Thomson Reuters

Graph 3
Banks' Profits*



* Adjusted for significant mergers and acquisitions
** 10 largest European and 5 largest UK banks
*** Implied from semi-annual data
Sources: Bloomberg; FDIC; banks' annual and interim reports

Graph 4
Banks' Securities Write-downs



Source: Bloomberg

posted profits of US$1.8 billion for the first half of 2009, having recorded a net loss of US$12 billion for the 2008 calendar year. In the United Kingdom, the five largest banks recorded combined profits of around £12 billion for the first half of 2009, after a loss of £20 billion in the second half of 2008. And in Europe, most large banking groups posted profits in both the first and second quarters of 2009.

One reason why profits have rebounded is that write-downs of securities have fallen. Data compiled by Bloomberg show that crisis-related losses on securities at around 100 large banks in the United States, Europe and the United Kingdom have fallen from around US$215 billion in the second half of 2008 to US$60 billion in the first half of 2009 (Graph 4). This has been driven by the sharp turnaround in many asset prices – just as the drop in confidence and the increased price of risk had undermined asset values through 2007 and 2008, the recent easing of risk aversion has supported valuations of risky assets. Favourable accounting treatment has also played a role in reducing write-downs, with rule changes allowing banks to avoid mark-to-market accounting on a broader range of assets. Large banks have generally been more affected by swings in securities values than smaller banks, as they tend to have a higher share of their assets in securities, after having grown these holdings significantly in the years preceding the crisis.

Another recent boost to profits, again particularly at large banks, has been the recovery in investment banking activity since markets began to thaw earlier this year. Banks with investment banking operations reported record income from debt and equity underwriting, as the backlog of debt issuance began to clear in the first quarter, and equity issuance picked up in the second quarter (as discussed below in the section on credit and wholesale funding markets). Banks also reported that profits have been boosted by strong client trading volumes and wider bid/ask spreads.

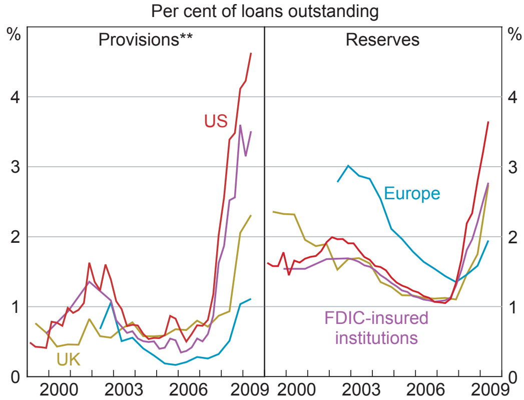
Loan loss provisions, however, have remained a significant drag on bank profitability in most countries. After lagging the increase in securities write-downs last year, loan write-offs have continued to increase as the challenging macroeconomic and financial conditions weigh on loan quality. A selection of large global banks for which data are available set aside aggregate provisions of US$142 billion for the first half of 2009, a 70 per cent increase on the same period in 2008, and an 8 per cent increase on the second half of 2008 (Graph 5). These banks' loan loss reserves now total around 3 per cent of loans, with the ratio higher for large US banks. For all US FDIC-insured institutions, the ratio of reserves to loans is at its highest level since the data series began in 1984.

The high loan losses reflect both high levels of non-performing loans and high write-off rates on those loans. In the United States, loan performance has deteriorated across all categories, although write-off rates on household exposures are particularly high compared to previous downturns, consistent with lax lending practices and large house price falls (Graph 6). Outside the United States, write-off rates are much lower, although many analysts forecast a rise in the period ahead. Because commercial property prices have fallen significantly in many countries, loans to this sector are expected to be among the worst performing. Future performance of banks' loan portfolios will depend on earlier lending practices and

Graph 5

Banks' Loan Loss Provisioning and Reserves*

Per cent of loans outstanding

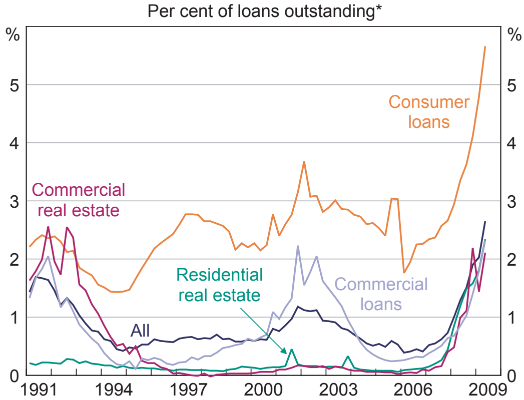


* Six largest US and five largest UK banks. Six largest European banks for which data are available. Adjusted for significant mergers and acquisitions.
** Annualised values of quarterly (US, FDIC and Europe) or semi-annual (UK) provisions; not seasonally adjusted.
Sources: Bloomberg; FDIC; banks' annual and interim reports

Graph 6

US Commercial Banks' Loan Charge-offs

Per cent of loans outstanding*



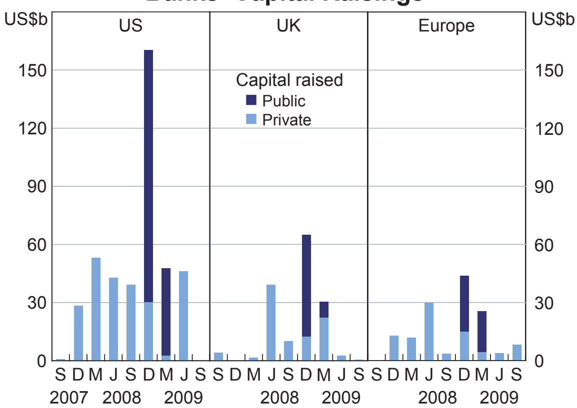
* Annualised values of quarterly charge-offs; seasonally adjusted
Source: Board of Governors of the Federal Reserve System

future developments in the macroeconomy and asset prices (discussed further below in the section on financial condition of the household and business sectors).

Higher profits have helped banks repair some of the damage done to balance sheets over the past two years. Banks have actively sought to reduce the levels of leverage and risk in their balance sheets by retaining profits, selling non-core assets and raising capital. In total, a collection of 21 large banks have raised around US$430 billion of capital since the fourth quarter of 2008, the bulk of this by US banks (Graph 7). While most of these funds initially came from government capital injections, around one third has been raised from private investors, much of this following the results of the US authorities' stress tests of 19 large US banks. Another way that banks have been bolstering their capital position has been by shrinking their balance sheets. While moves to reduce assets and de-risk balance sheets may be sensible from the perspective of an individual institution, collectively, aggressive balance sheet reduction could depress asset prices and constrain the real economy, which would then feed back onto the financial sector.

Graph 7

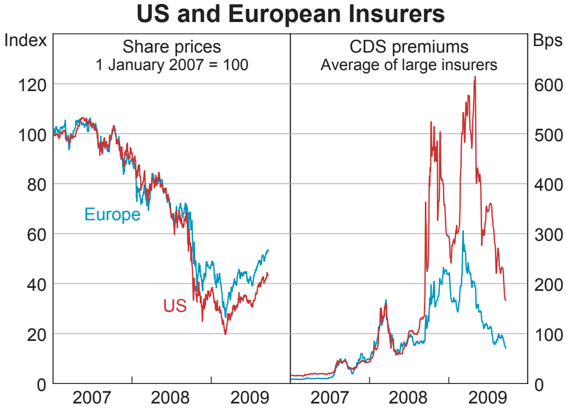
Banks' Capital Raisings*



* Six largest US banks, five largest UK banks and ten largest European banks. Adjusted for significant mergers and acquisitions.
Source: Bloomberg

Graph 8

US and European Insurers



Sources: Bloomberg; RBA

Other parts of the financial system have also benefited from the better conditions. A number of large US and European insurance companies have returned to profit in the first half of 2009, after losses in the second half of 2008 flowing from asset price falls. Accordingly, share price indices and CDS premiums of insurers have retraced part of the movement from the peak of the crisis (Graph 8). US mortgage insurers, however, continue to be affected by weakness in the US housing market, with many still reporting losses in the first half of 2009. Hedge funds returned to profitability in the second quarter of 2009 and, following record levels of redemptions during the second half of 2008, the value of funds under management has steadied in 2009.

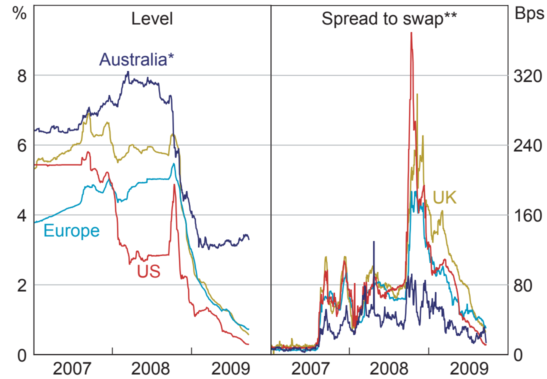
Credit and Wholesale Funding Markets

Greater confidence in banking systems is also evident in global bank funding markets. In all major short-term money markets, risk spreads have returned to levels prevailing in 2007, taking market interest rates to very low levels (Graph 9). In global long-term markets, risk spreads on bank bonds have retraced much of the widening seen over 2008, though they are closer to returning to levels preceding the crisis for higher-rated institutions than lower-rated institutions (Graph 10). These developments have encouraged banks to make greater use of normal funding arrangements, and to reduce their use of the support measures introduced by authorities when funding conditions were strained (as discussed below in the section on efforts to support the financial sector).

With the extreme pressure on the financial sector alleviated, earlier widespread fears of a debilitating feedback loop running from the financial sector to the economy and back to the financial sector have somewhat abated. Nonetheless, the credit supply process in the major economies remains significantly challenged. Banks in the United States and euro area continued to report a net tightening of lending standards for business and housing loans around mid-year, although the share of banks reporting tighter standards is below earlier peaks (Graph 11). A majority of US banks continued to report that they increased risk spreads on business

Graph 9

3-month LIBOR

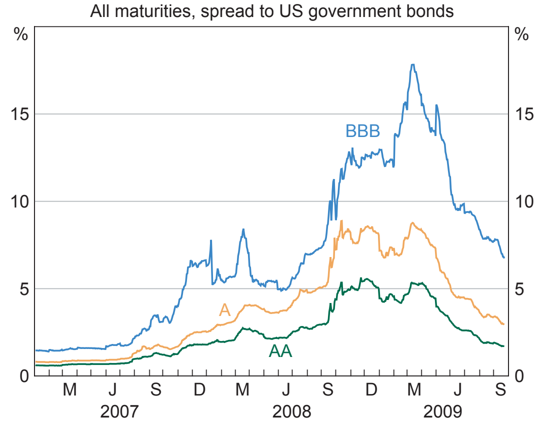


* Bank bills
** Spread is to: OIS in Australia and US; EONIA in Europe; and SONIA in UK
Sources: Bloomberg; Tullett Prebon (Australia) Pty Ltd

Graph 10

US Bank Bond Spreads

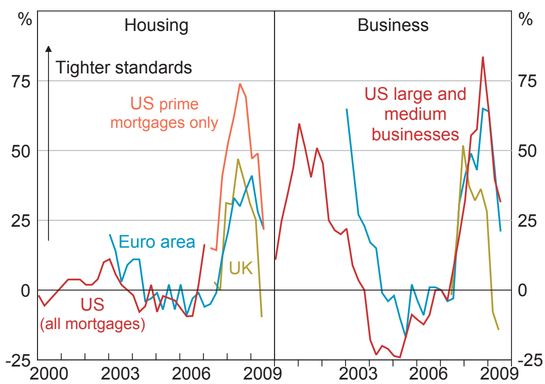
All maturities, spread to US government bonds



Source: Bloomberg

Graph 11

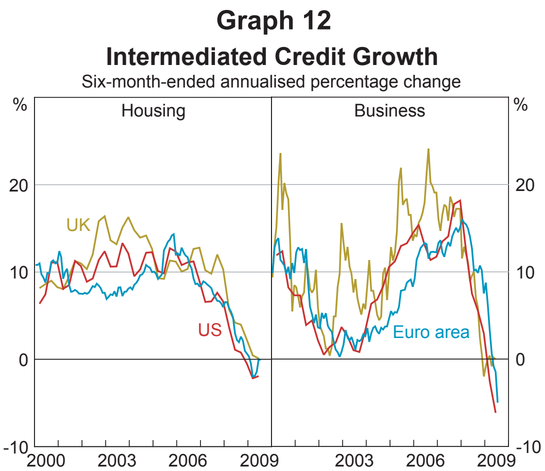
Credit Standards*



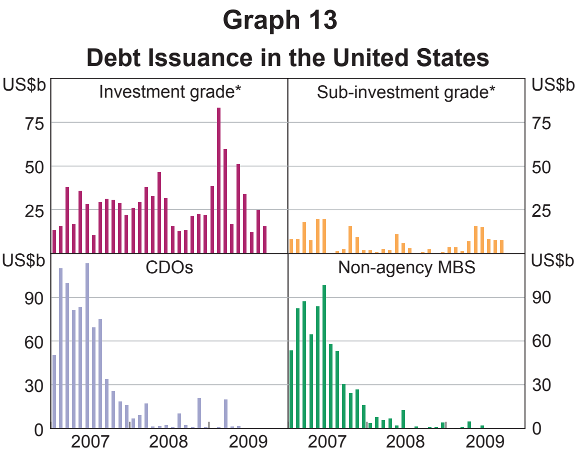
* Net percentage reporting tightening standards. US and Europe ask whether *lending standards* have changed. UK asks whether the *supply of credit* has changed. UK applies twice the weight to a 'considerably' answer relative to a 'somewhat' answer. US and Europe apply an equal weight.
Sources: Bank of England; Board of Governors of the Federal Reserve System; ECB

loans in the June quarter. Demand for credit is also weak, with many households and businesses looking to strengthen their financial position by reducing their leverage.

Consistent with these supply and demand conditions, credit growth remains weak. Over the recent six-month period credit growth has continued to fall in the major markets and is now in low single digits or negative on an annualised basis (Graph 12). Both housing and business credit growth are well below their decade averages. Leading indicators generally suggest some signs of stabilisation in housing credit growth though there are fewer signs of this for business credit growth, partly because some businesses are increasing their funding through wholesale markets.



Sources: Bank of England; Board of Governors of the Federal Reserve System; ECB; RBA



* Non-financial corporate issuance; September data are month to date
Sources: JPMorgan; SIFMA; Thomson Reuters

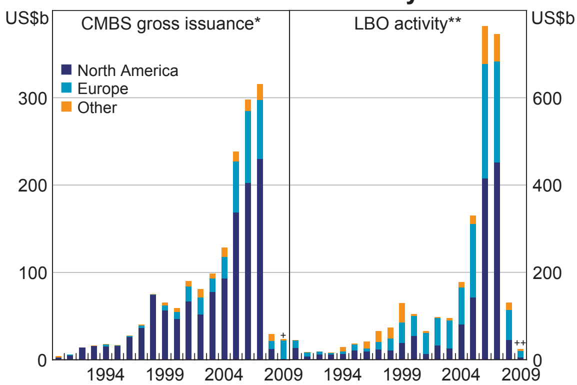
Some caution among lenders and borrowers also remains evident in non-financial wholesale debt markets. As with bank bonds, risk spreads have narrowed sharply from their post-Lehman collapse peaks, though investors have discriminated by credit quality; for example, spreads on AAA corporate bonds are back to their mid 2007 level, while those for lower-rated bonds remain well above. This has been reflected in issuance patterns; issuance of collateralised debt obligations (CDOs) and non-agency mortgage-backed securities (MBS) remains negligible, but issuance of conventional corporate bonds in 2009 to date already exceeds 2008 (Graph 13). Much of the corporate bond issuance in the United States occurred early in 2009, partly reflecting pent-up demand and willingness to lock in funding following the post-Lehman turmoil.

Commercial mortgage-backed securities (CMBS) and leveraged buyout (LBO) transactions are further examples of markets where, in the lead-up to the crisis, strong growth in debt had been used to finance activity in rising asset markets, but investors now remain cautious. Issuance of CMBS globally has been minimal, at around US$25 billion in 2009 to date, down from annual volumes of US$300 billion at the peak (Graph 14). In addition, investors are carefully scrutinising maturity profiles of existing borrowers for refinancing risk. Firms which participated in LBO transactions around the market peak are also facing close monitoring. In some regions, these firms have found that they have only limited access to their traditional bank and syndicated lending financing methods. Unsurprisingly, the value of new LBO deals remains subdued, with only US$24 billion announced and completed globally so far this year, well down from the annual totals in 2006 and 2007 of more than US$700 billion.

Given shocks to balance sheets and operating conditions, many firms are looking to raise equity and reduce their leverage rather than take on debt. The stronger tone in equity markets since March has enabled a strong pick-up in equity issuance by listed firms, though initial public offerings (IPOs) remain very subdued (Graph 15). Much of the equity raised has been used by firms to pay back debt or otherwise bolster balance sheets so as to lower refinancing risk. Firms have also sought to increase capital by lowering dividends.

Graph 14

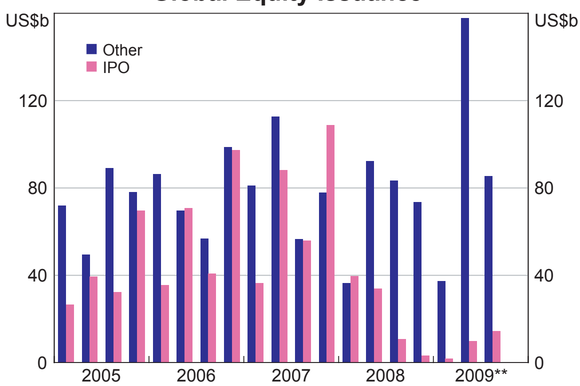
Global Market Activity



* Excludes issuance of multi-family residential CMBS by the US government-sponsored enterprises
** Announced
\+ Issuance to July 2009
\++ Activity to September 2009
Sources: Commercial Mortgage Alert; Commercial Mortgage Securities Association; Thomson Reuters

Graph 15

Global Equity Issuance*



* Includes all underwritten equity issuance by the 253 largest underwriters
** September quarter is quarter to date
Source: Bloomberg

Efforts to Support the Financial Sector

Actions by the authorities have been important in turning sentiment around and restoring confidence in the financial sector. In addition to the broader support from the fiscal and monetary stimulus introduced over the past couple of years, the financial sector has benefited from a range of specific actions implemented in a number of countries throughout the crisis period, particularly in the wake of the Lehman Brothers collapse in September 2008. As detailed in the March 2009 *Financial Stability Review*, authorities had widely moved to strengthen bank funding with extraordinary central bank liquidity support, increased depositor protection arrangements and provision of government guarantees for wholesale funding. Further, authorities in a number of countries had stepped in to support the capitalisation of financial institutions by injecting public funds, and to address concerns about risk exposures by absorbing some of the risk on troubled assets.

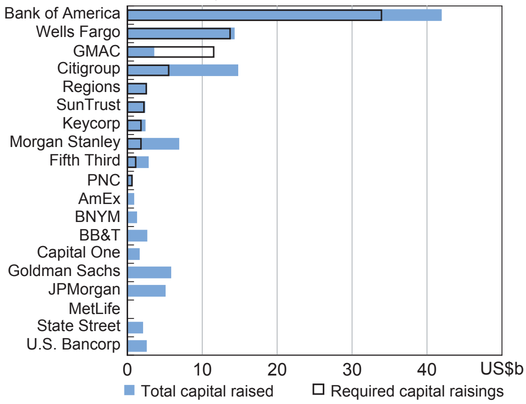
As improved sentiment has taken hold since March, there have been fewer new financial sector support initiatives, and some of the previously implemented assistance is being wound back. Removal of support arrangements, however, remains a significant policy challenge. It is in the long-run interest of the financial system for institutions to rely on their own credit standing rather than official sector support, as long as the withdrawal of arrangements can be accomplished without destabilising markets and confidence.

A noteworthy action, addressing concerns about **capital levels** of banks that persisted earlier in the year, was the US authorities' stress tests of 19 large US banks. The results, released by the US Federal Reserve in May, found that 9 of the 19 banks did not require further capital to meet target capital adequacy ratios in a severe downturn scenario. Of the 10 that did, most implemented or announced measures that allowed them to achieve their target soon thereafter (Graph 16). The results, and the subsequent rapid private capital raisings by some banks, were viewed favourably by investors.

Graph 16

Capital Raisings by the Largest US Banks

Announced or completed since end March 2009



Sources: Board of Governors of the Federal Reserve System; company reports

In a number of cases, earlier public equity injections have been returned. As US banks have raised private capital, they have repaid around one third of the total funds previously invested by the US Government as part of its capital purchase program. However, many smaller banks are yet to repay their funds and new public capital injections into smaller banks are still occurring, indicating a broad dispersion in the health of US banks. There have also been examples of private capital replacing public in other countries. The Swiss Government has begun withdrawing its support of the large bank UBS, by converting CHF6 billion of mandatory convertible notes into UBS shares, which were subsequently sold to institutional investors at a considerable overall profit to the Swiss Government given dividends paid. AEGON, a large Dutch insurer, has recently raised €1 billion in equity with the aim of partly repaying a loan extended by the Dutch Government in October 2008.

There have been some further actions by authorities on programs to deal with financial institutions' **troubled asset exposures**, though improved market conditions and higher prices for many assets seem to have reduced the urgency of authorities and potential participants in pursuing these often complex measures. In March, the US authorities announced further details of the program to remove troubled loans and securities from banks but the program is yet to be fully implemented and the arrangements have been revised. In April and May, Ireland and Germany joined the list of countries that have announced troubled asset schemes, though the Irish scheme is not yet operational and the German scheme has not been used. In the United Kingdom, there have been no further deals under its program since the two transactions in February and March. In general, these troubled asset schemes have been less utilised than capital injection programs, raising concerns among some commentators about complacency in dealing with these exposures.

As risk spreads have narrowed, financial institutions have made less use of official **support for wholesale funding.** In many cases these support measures were designed so that their use would become increasingly unattractive as markets returned to more normal conditions.

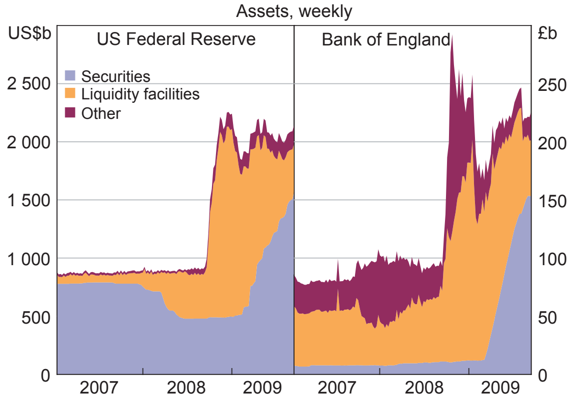
In short-term funding there has been less drawing on central bank liquidity facilities. For example, assets purchased under liquidity facilities at the US Federal Reserve have fallen from as high as US$1.6 trillion in late 2008 to around US$410 billion in September, and from around £190 billion to £50 billion at the Bank of England (Graph 17). Nonetheless, balance sheets of these central banks remain considerably larger than normal. The fall in short-term liquidity facilities has been offset by an increase in assets that have been purchased directly by the central banks, such as mortgage-backed securities, to assist market functioning and the monetary policy transmission mechanism by promoting the pass-through of lower rates to end borrowers. As a result of these purchases, many borrowing rates are lower than would otherwise be the case.

The amount of term debt issued by banks and backed by government guarantee schemes has also slowed, particularly in the United States and United Kingdom, compared to the first quarter of 2009 (Graph 18). This partly reflects that some, mainly higher-rated, banks have been issuing unguaranteed debt as the risk appetite of investors has increased and risk spreads have narrowed, although the overall cost of guaranteed issuance appears to remain cheaper for most banks (i.e. the yield spread between unguaranteed and guaranteed bonds is wider than the fee for using the guarantee). Lesser use of the government guarantees also partly reflects that issuance earlier in the year included banks' pent-up demand for funding. With lending growth currently slow, banks have less overall demand for funding, as suggested by lower total

Graph 17

Central Bank Balance Sheets

Assets, weekly

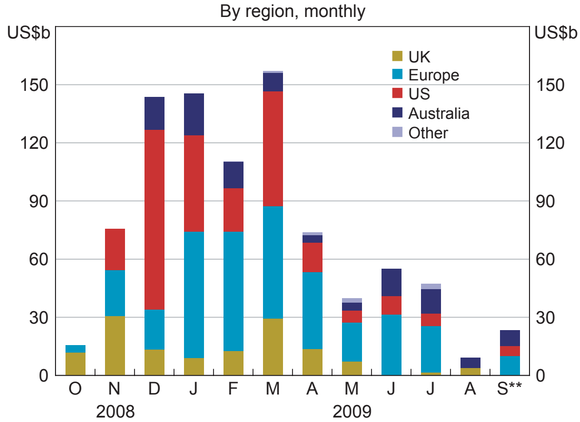


Sources: Bank of England; Board of Governors of the Federal Reserve System

Graph 18

Government-guaranteed Bond Issuance*

By region, monthly



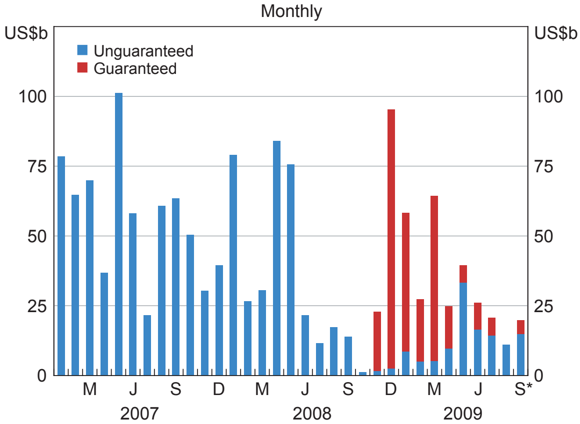
* May exclude some private placements

** Month to date

Sources: RBA, Thomson Reuters

Graph 19

US Financials' Bond Issuance



* September data is month to date

Sources: RBA; Thomson Reuters

bond issuance by US financial firms (Graph 19). In addition, actions by authorities have sometimes worked against the use of the guarantees. In the United States, institutions must stop using the guarantee program in order to repay public capital and thereby eliminate restrictions on executive remuneration. In Europe, the ECB initiated a €60 billion covered bond purchase program that has enabled banks to raise funding in this market, rather than issuing guaranteed debt.

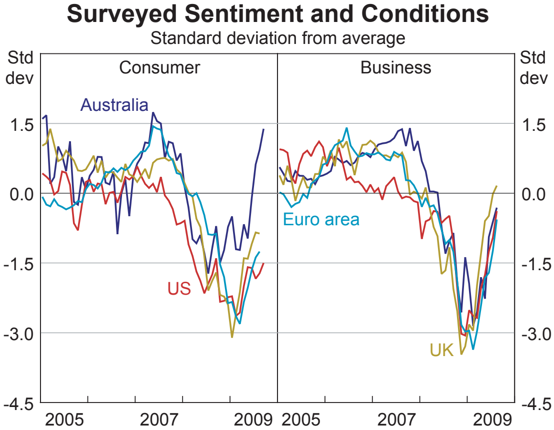
Attention is moving to how to exit from these government support arrangements. The US authorities have recently confirmed their intention to close the existing US scheme at the end of October. In many other countries, authorities have previously stated that issuance under the schemes will end in 2009, though the French Government recently announced a one-year extension of its scheme. Exit strategies from the guarantee arrangements have been a focus of discussion in international fora (see the *Developments in the Financial System Architecture* chapter). The broader issues of addressing the underlying causes of the crisis, and how to exit from highly stimulatory fiscal and monetary policies while balancing competing concerns about growth, inflation, crowding-out of private borrowers and, in some cases, the health of government finances, are other challenging policy issues being considered that will have important implications for financial institutions.

Financial Condition of the Household and Business Sectors

The crisis period has been marked by sharp swings in sentiment, both in financial markets and among households and businesses. In late 2008 and early 2009, measures of consumer and business confidence fell sharply, threatening a highly contractionary fall in spending that could, in turn, aggravate financial sector weakness (Graph 20). In the past six months confidence indicators have recovered somewhat, in line with the improved tone in financial markets, although in most countries they remain below their pre-crisis levels, consistent with the lingering negative effects of lower asset

Graph 20

Surveyed Sentiment and Conditions



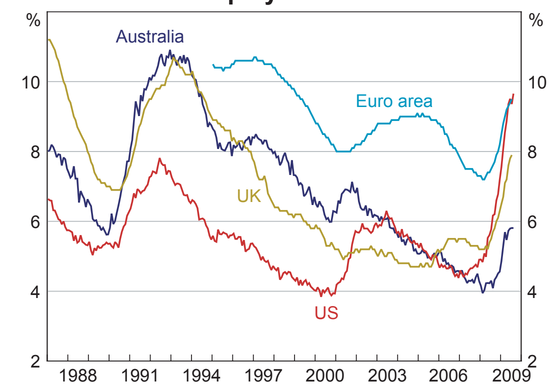
Sources: JPMorgan Chase & Co. and Markit; Melbourne Institute and Westpac; NAB; RBA; Thomson Reuters prices and slower macroeconomic growth on balance sheets and incomes. In this environment, households and businesses continue to take a more cautious approach to borrowing and spending than in recent years, and measures of loan quality have generally continued to deteriorate.

A significant drag on the financial position of households has been the weaker labour markets, particularly the rise in unemployment. Of the major countries this has been most pronounced in the United States, where the unemployment rate has risen by 5 percentage points in 18 months to reach 9.7 per cent in August, the highest since the early 1980s, with a further increase anticipated (Graph 21). In Europe and the United Kingdom, the rise in the unemployment rate to date is around 2 percentage points. Growth in underlying household income in these countries has weakened accordingly, though government transfers and lower interest rates have generally cushioned the effect on disposable income growth rates.

Household balance sheets remain negatively affected by developments in asset markets over recent years. The value of financial asset holdings has fallen sharply and prices of housing – typically the largest asset class for the household sector – have also registered large falls in many countries, with prices in the United States and United Kingdom down 30 and 20 per cent from their peaks (Graph 22). More recently, the fall in household assets has been arrested, as a result of gains in financial markets and signs of stabilisation in some housing markets, with some recent monthly house price gains in the United States and United Kingdom.

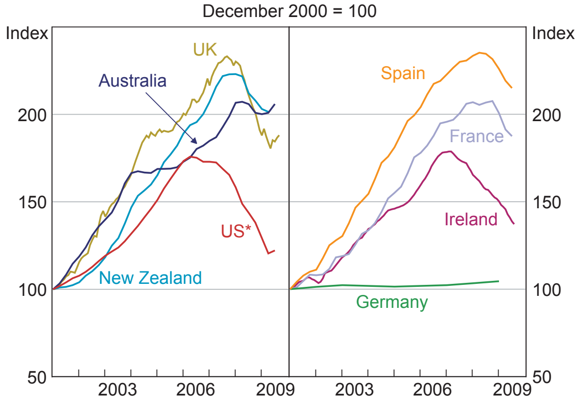
With higher unemployment and lower house prices impeding households' ability to service and repay debt, mortgage arrears are rising in a number of countries. Of the major countries, the United States stands out as having the worst-performing housing loans. The 30+ days arrears rate on all mortgages has risen to 9.2 per cent in June 2009, from 7.9 per cent in December 2008, reflecting increases in all loan categories (Graph 23). A particular concern for lenders is that falls in house prices have pushed many borrowers into 'negative equity', where the value of the loan exceeds the value of the property. Private sector estimates suggest that around

Graph 21
Unemployment Rates



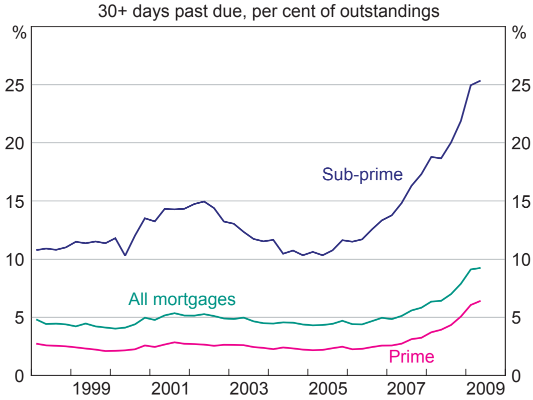
Sources: ABS; Thomson Reuters

Graph 22
Dwelling Prices
December 2000 = 100



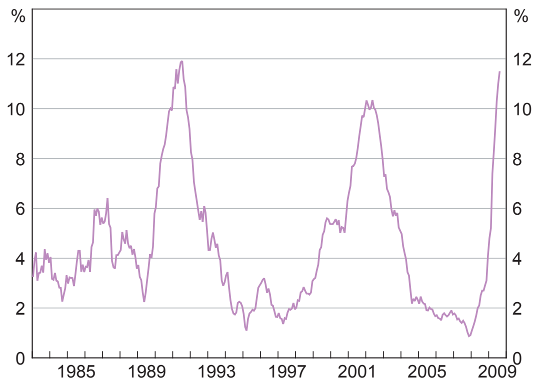
* Prices of detached houses only
Sources: APM; Bloomberg; RBA; Thomson Reuters

Graph 23
US Mortgage Delinquency Rates
30+ days past due, per cent of outstandings



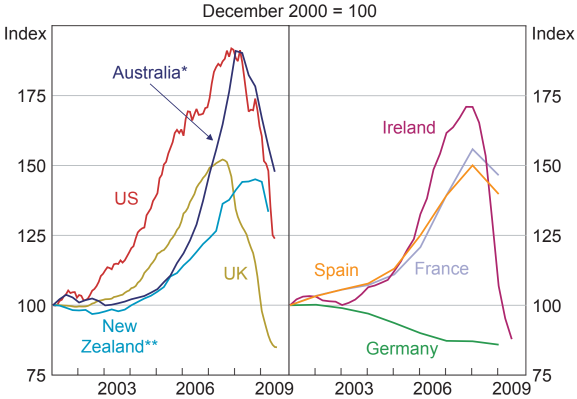
Source: Mortgage Bankers Association

Graph 24
Moody's Global Speculative-grade Default Rate



Source: Moody's

Graph 25
Commercial Property Prices
December 2000 = 100



* Prime office space only
** Seasonally adjusted
Sources: Bloomberg; Jones Lang LaSalle; RBA

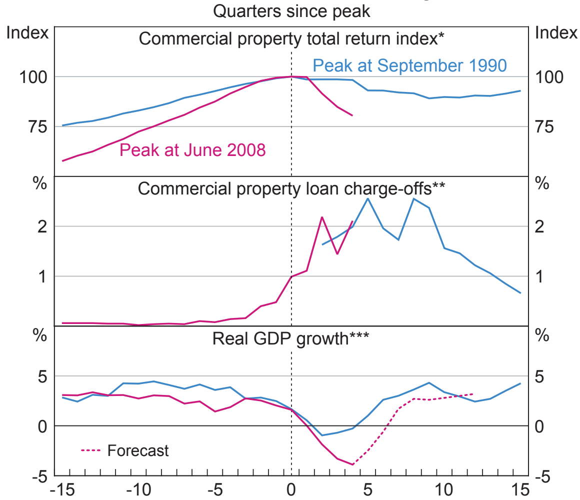
one third of mortgaged homes are in negative equity – with one eighth owing more than 125 per cent of their property's value. In contrast, in the United Kingdom, the Bank of England estimates that between 7 and 11 per cent of owner-occupier mortgages are in (mostly marginal) negative equity.

Businesses are also experiencing tighter credit conditions, lower cashflow and weakened balance sheets, and measures of financial difficulty have generally increased. For example, Moody's global speculative-grade default rate has increased by 9 percentage points over the 12 months to August 2009 to 11.5 per cent, the highest rate since the early 1990s (Graph 24). This rate is, however, forecast by Moody's to decline over 2010. As with households, debt-servicing burdens have been alleviated by sharp reductions in policy rates, even though risk margins have widened. Concerns about businesses' ability to refinance maturing debt have lessened in recent months, along with the easing in extreme risk aversion, though lenders and investors remain cautious. Asset exposures remain problematic for a number of firms given earlier price falls, particularly those that are highly geared. In this environment, as discussed above in the section on credit and wholesale funding markets, many firms are looking to reduce leverage, and equity raisings have picked up while business credit growth continues to fall.

A particular area of weakness has been companies with commercial property exposure. Commercial property prices in most markets have been pressured recently by rising vacancy rates, increased risk aversion and tough financing conditions in both intermediated and non-intermediated markets. In the United States and United Kingdom, prices have fallen even further than house prices (Graph 25). Prices of other commercial property-related assets, such as share prices of listed property companies, have shown improvement in recent months, but have generally not risen by as much as broader indices.

Graph 26

US Commercial Property



* Includes income and capital returns; peak of index = 100

** Per cent of value of loans outstanding; seasonally adjusted annualised quarterly charge-offs

*** Year-ended percentage change

Sources: Board of Governors of the Federal Reserve System; Consensus Economics; NCREIF; Thomson Reuters

The effects of the poorly performing global commercial property market are being felt on banks' balance sheets. In the United States, reflecting a delinquency rate of almost 8 per cent, banks' commercial property charge-offs reached 2.1 per cent in the June quarter 2009 – only marginally lower than the levels experienced during the early 1990s. The experience of the 1990s, where the cycle in total returns was less pronounced, was that charge-offs continued at a high rate for a considerable period after the peak (Graph 26).

The Australian Financial System

The Australian financial system has continued to perform relatively strongly over the past six months. The Australian banking sector has reported solid profits, and has further strengthened its capital position; the largest banks have maintained their high credit ratings. Funding conditions have also improved as the extreme risk aversion prevailing around the turn of the year has abated. Banks have ready access to debt funding and, with investor risk appetite returning, the higher-rated banks have increased issuance of debt not supported by the Government guarantee. Deposit growth has slowed in recent months, but remains firm. While the outlook has improved, the banking system continues to face some important challenges, including the prospect of problem loans rising further from the very low levels of recent years.

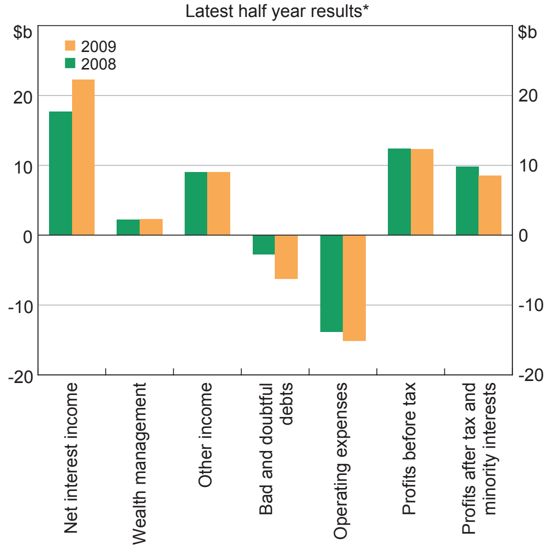
Profits and Asset Quality of the Banking System

In contrast to those in many other countries, the Australian banking system has reported solid profits throughout the financial turmoil. The four major banks recorded total headline profits after tax and minority interests of around $8.6 billion in the latest half year (to March for three of them and to June for the other), which represents an annualised post-tax return on equity of around 13½ per cent (Graph 27). Although this was a strong outcome, profits were around 14 per cent lower than in the same period a year earlier, after adjusting for recent mergers. The smaller banks, including the regionals, have also remained profitable in recent years, but have reported a more pronounced downturn in aggregate profitability (Graph 28).

Graph 27

Major Banks' Profits

Latest half year results*

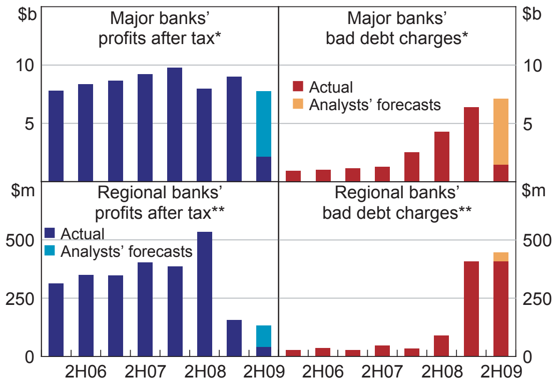


* Half year to June for CBA and half year to March for ANZ, NAB and Westpac. Includes St George, and Bankwest in 2009.
Sources: Banks' annual and interim reports

A number of interrelated factors have contributed to the relatively strong performance of the Australian banking system in the face of the challenges of the past couple of years. One is that Australian banks typically entered the financial turmoil with only limited direct exposures to the types of securities – such as CDOs and US sub-prime RMBS – that led to losses for many banks abroad. Moreover, they have typically not relied on the income streams most affected by recent market conditions: trading income only accounted for around 5 per cent of the major banks' total income prior to the turmoil. Banks' wealth management operations have been affected by market developments,

Graph 28

Australian Banks' Profitability



* First half figures are half year to December for CBA and half year to March for ANZ, NAB and Westpac. Includes St George, and Bankwest from second half of 2009.

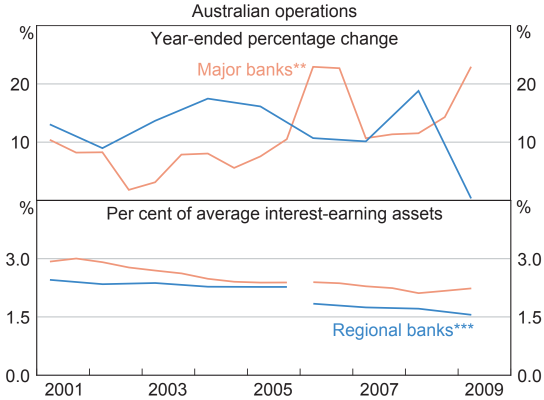
** First half figures are half year to December for Suncorp-Metway and Bendigo and Adelaide Bank, and half year to February for Bank of Queensland.

Sources: Citigroup; Morgan Stanley; RBA; UBS; banks' annual and interim reports

Graph 29

Banks' Net Interest Income*

Australian operations



* From 2006 data are on an IFRS basis; prior years are on an AGAAP basis.

** First half figures are annualised half year to June for CBA and half year to March for ANZ, NAB and Westpac. Includes St George, and Bankwest in 2009.

*** 2009 figures are full year to June for Suncorp-Metway and Bendigo and Adelaide Bank, and annualised half year to February for Bank of Queensland.

Sources: RBA; banks' annual and interim reports

but the major banks still reported net income of around $2.3 billion from these activities in the latest half year.

One reason why Australian banks garnered a relatively low share of their income from trading and securities holdings is that they did not have as much incentive as many banks around the world to seek out higher-yielding, but higher-risk, offshore assets. In turn, this was partly because they were earning solid profits from lending to domestic borrowers, and already required offshore funding for these activities. As a result, Australian banks' balance sheets are heavily weighted towards domestic loans, particularly to the historically low-risk household sector. While domestic non-performing loan ratios have risen recently, they remain lower than in many other countries, reflecting a stronger economy, better lending standards and a proactive approach to prudential supervision (see below).

Because Australian banks focus on domestic lending, their profits continue to be underpinned by growth in net interest income. For the major banks, net interest income increased by 22 per cent over the past year (after adjusting for mergers) as a result of the ongoing expansion of their balance sheets (Graph 29). Net interest income also accounted for most of the regional banks' profits, though its growth has moderated over the past year or so. After a decade of declines, the interest rate margin that the major banks earned on their domestic lending increased slightly over the past year, from 2.11 per cent to 2.24 per cent. In contrast, overall interest margins at some of the smaller banks still appear to be under downward pressure, reflecting strong competition for deposits, higher wholesale funding costs and their generally higher share of assets in housing loans, where margins have not widened as much as on business loans.

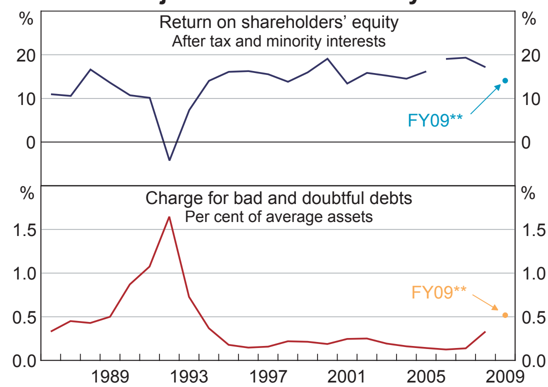
The recent decline in bank profits has been mainly due to a rise in provisioning charges. The major banks reported charges for bad and doubtful debts of $6.2 billion in the latest half year, compared with $2.8 billion in the same period a year earlier (Graph 30). This is up from the low charges over recent years, but well below the expense for bad and doubtful debts incurred in the early 1990s (see Box A) and by major banks in the United States and Europe. This recent rise in the bad debts expense partly reflects an increase in the collective provisions that banks hold against a general deterioration in their loan portfolios, such as that arising from the downturn in economic conditions, both in Australia and overseas. It also reflects higher individual provisions, including against exposures to highly leveraged companies that are often the first to experience difficulties when economic conditions turn for the worse. Provisioning expenses have also increased at the regional banks from a low base: they reported a $360 million rise in provisioning charges over the past year.

The major banks' trading updates and analysts' expectations suggest that provisioning charges are likely to rise further in the near term, to a peak equivalent to around 0.6 per cent of their average assets for the 2010 financial year, before improving thereafter. Consistent with their anticipated profile for bad debt charges, analysts generally expect banks' return on equity to increase a little in the 2011 financial year.

The higher provisioning charges reflect a rise in banks' non-performing assets. The ratio of these to total on-balance sheet assets stood at around 1.5 per cent as at June 2009, compared to 0.7 per cent

Graph 30

Major Banks' Profitability*

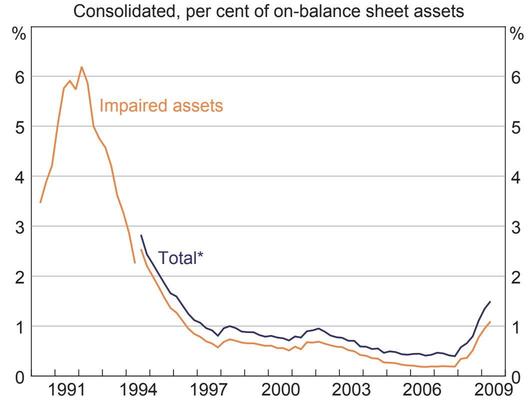


* From 2006 data are on an IFRS basis; prior years are on an AGAAP basis. Includes St George.
** 2009 figure is calculated as the full year to June for CBA and annualised half year to March for ANZ, NAB and Westpac. Includes Bankwest.
Sources: RBA; banks' annual and interim reports

Graph 31

Banks' Non-performing Assets

Consolidated, per cent of on-balance sheet assets

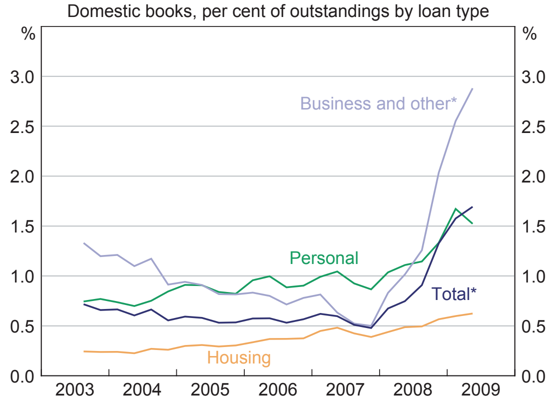


* Includes 90+ days past-due items that are well secured
Source: APRA

Graph 32

Banks' Non-performing Loans

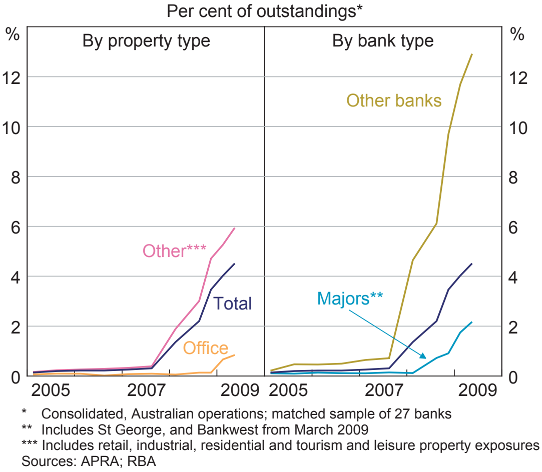
Domestic books, per cent of outstandings by loan type



* Includes bill acceptances and debt securities
Sources: APRA; RBA

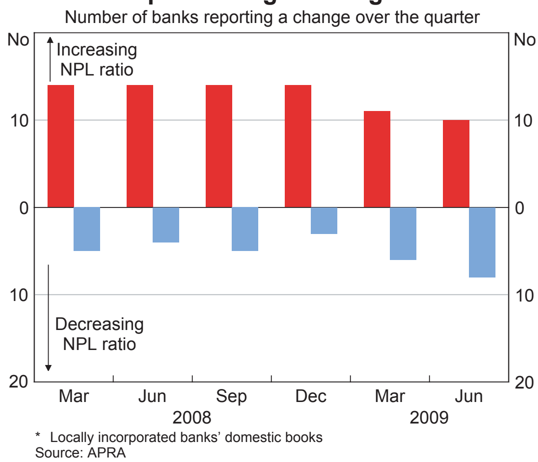
Graph 33

Commercial Property Impaired Assets



Graph 34

Banks' Non-performing Housing Loan Ratios*



a year earlier (Graph 31). It is around 80 basis points above its average over the past decade, but still well below the early 1990s peak of over 6 per cent. Around one quarter of these non-performing assets are classified as 'past due' but not impaired, meaning that the outstanding amount is well covered by the value of collateral, even though repayments are overdue by at least 90 days.

The rise in non-performing loans (NPLs) has been evident across each of the main segments of the domestic loan portfolio, but it has been most pronounced in lending to businesses. The business (including financials) NPL ratio rose from 0.9 per cent to 2.9 per cent over the year to June 2009 (Graph 32). This increase was initially mainly due to a small number of exposures to highly geared companies with complicated financial structures and/or exposures to the commercial property sector, but it has become more widespread recently as the economy has slowed.

In banks' commercial property loan portfolios, the impaired assets ratio stood at around 4½ per cent as at June 2009, compared to around 1½ per cent in early 2008 (Graph 33). This ratio is now higher than it has been for some time, but is lower than the levels reached in the early 1990s. Much of the rise has been accounted for by loans for retail property and, more recently, residential development. In contrast to the early 1990s, there has been only a relatively small rise in impaired loans for office property. The rise has been less pronounced for the majors than the smaller banks.

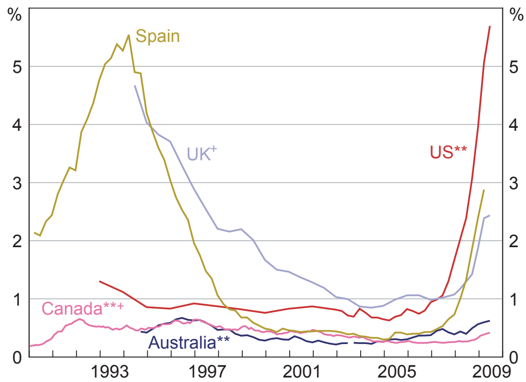
In the mortgage portfolio – which accounts for over half of banks' on-balance sheet loans – the aggregate NPL ratio has also continued to rise, to 0.62 per cent as at June 2009, compared to 0.49 per cent a year earlier. There has, however, been an improvement in NPL ratios across some banks' housing loan portfolios over the past three months, with nearly half of the locally incorporated banks reporting a decline over the June quarter 2009 (Graph 34). Housing loan arrears rates for Australian credit unions and building societies are lower than for banks and, at 0.15 per cent and 0.35 per cent, are around the same levels as in 2005. While the recent declines in interest rates have helped to alleviate debt-servicing pressures for some borrowers, higher unemployment represents a source of risk to authorised deposit-taking institutions' (ADIs) housing portfolios.

Despite the recent increase in the bank housing NPL ratio, it remains low by international standards. In the United States and United Kingdom, which have experienced both a housing market correction and banking sector problems, the comparable NPL ratios were around 5.7 per cent and 2.4 per cent (Graph 35). As discussed in detail in the previous *Review*, there are several factors that have contributed to the relatively strong outcome in Australia, including:

Graph 35

Non-performing Housing Loans

Per cent of loans*

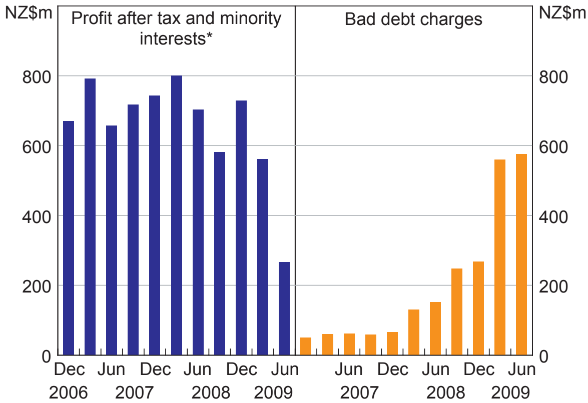


* Per cent of loans by value. Includes 'impaired' loans unless otherwise stated. For Australia, only includes loans 90+ days in arrears prior to September 2003.
** Banks only.
\+ Per cent of loans by number that are 90+ days in arrears.
Sources: APRA; Bank of Spain; Canadian Bankers' Association; Council of Mortgage Lenders; FDIC; RBA

- Lending standards were not eased to the same extent as elsewhere. For example, riskier types of mortgages, such as non-conforming and negative amortisation loans, that became common in the United States, were not features of Australian banks' lending.
- The level of interest rates in Australia did not reach the very low levels that had made it temporarily possible for many borrowers with limited repayment ability to obtain loans, as in some other countries.
- All Australian mortgages are 'full recourse' following a court repossession action, and households generally understand that they cannot just hand in the keys to the lender to extinguish the debt.
- The legal environment in Australia places a stronger obligation on lenders to make responsible lending decisions than is the case in the United States.
- The Australian Prudential Regulation Authority (APRA) has been relatively proactive in its approach to prudential supervision, conducting several stress tests of ADIs' housing loan portfolios and strengthening the capital requirements for higher-risk housing loans.

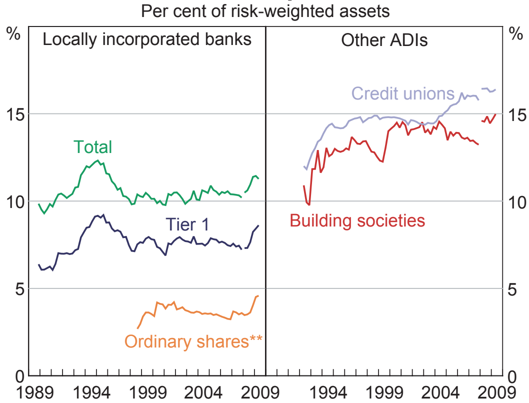
Part of the increase in Australian banks' bad debts has been due to their overseas operations, particularly in New Zealand and the United Kingdom where economic conditions have weakened significantly. As at June 2009, the Australian banks' overseas exposures accounted for around one quarter of their total assets, with New Zealand and the United Kingdom together

Graph 36
Major Banks' New Zealand Subsidiaries
Profitability



* Excludes effects of the Visa IPO and one-off tax expenses
Sources: Banks' disclosure statements

Graph 37
ADIs' Capital*
Per cent of risk-weighted assets



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

accounting for about two thirds of these foreign exposures. The recent downturn in economic conditions in these two countries has been associated with falls in property prices, contractions in lending, and increases in non-performing loans and provisions. In New Zealand, the major banks' subsidiaries have remained profitable, despite the increase in non-performing loans, because of solid net interest income (Graph 36).

Capital and Liquidity

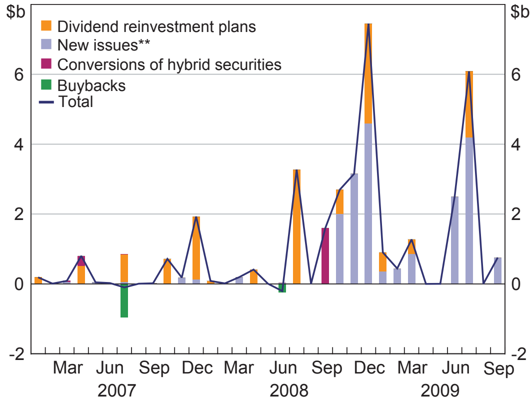
The Australian banking system remains soundly capitalised.The sector's Tier 1 capital ratio rose by 1.3 percentage points over the 12 months to June 2009 to 8.6 per cent, its highest level in over a decade (Graph 37). In contrast, the Tier 2 capital ratio has fallen by around 0.7 percentage points over the same period, mainly because term subordinated debt declined. As a result of these developments, the banking system's total capital ratio has risen by almost 0.7 percentage points over the past year, to stand at 11.3 per cent as at June 2009. A similar pattern has been evident in a simpler measure of leverage – the ratio of ordinary shares to (unweighted) assets – which has risen by around half a percentage point over the past six months. The credit union and building society sectors are also well capitalised, with aggregate total capital ratios of 16.4 per cent and 15 per cent.

The rise in the banking system's Tier 1 capital ratio largely reflects the significant amount of new equity that has been issued over the past year or so. In 2009 to date, the major banks have issued a combined $12 billion of ordinary equity, with recent placements being heavily oversubscribed and priced at only modest discounts to share prices (Graph 38). These banks have also scheduled a further $2.1 billion of issuance of other Tier 1 capital instruments in the near term. The regional banks have issued around $1.9 billion of ordinary equity this year. These initiatives have seen the share of banking system capital accounted for by ordinary equity rise to around 45 per cent as at June 2009, after this share had fallen to 32 per cent a few years ago. In large part, these developments reflect procyclical market pressure for listed banks to raise additional equity, in contrast to earlier years when there was little new issuance, and some ordinary equity buybacks. At the same time, markets are focusing on the composition of banks' capital, which has seen a fall in outstanding Tier 2 capital instruments such as term subordinated debt, after strong issuance in the earlier part of the decade.

In response to falling profits, many banks have cut their dividends (Graph 39). Despite these lower dividends, the major banks' dividend payout ratio increased to around 80 per cent over the past year.

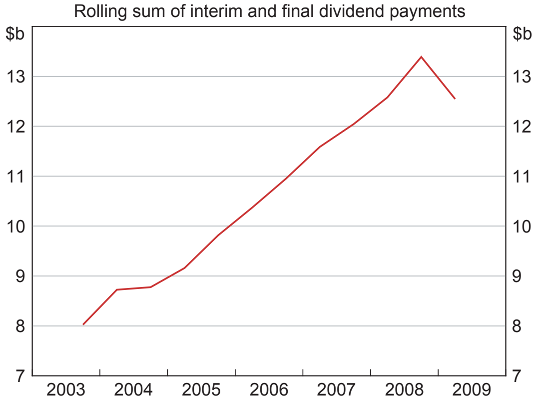
Banks are also holding significantly more liquid assets than they were prior to the onset of the financial turmoil, reflecting an increased focus on liquidity in the current environment. Following a step-up in the second half of 2007, the share of their total domestic assets accounted for by cash, deposits, and highly marketable domestic securities has been broadly unchanged at around 16 per cent; if banks' 'self securitisations' are included it would be around 22 per cent as at July 2009 (Graph 40). Whereas the bulk of the earlier rise in the liquid assets ratio reflected increased holdings of securities issued by other ADIs, the share of liquid assets accounted for by government securities has risen recently, from a low base. Banks' holdings of government securities are equivalent to around one quarter of the current stock outstanding.

Graph 38
Major Banks' Equity Raisings*



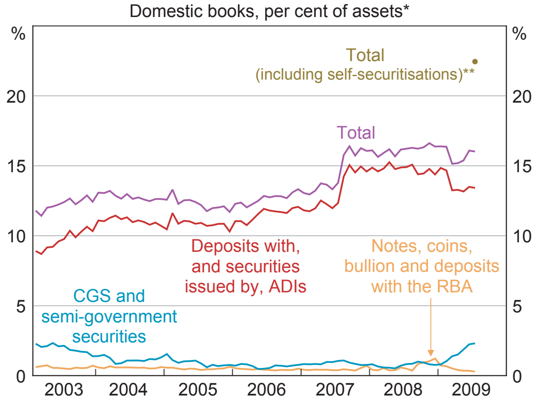
* Excludes acquisitions. Includes St George. September 2009 observation is estimate of month to date.
** Includes new placements and employee share purchase plans.
Sources: ASX; banks' websites

Graph 39
Major Banks' Dividend Payments*
Rolling sum of interim and final dividend payments



* Contains reinvested dividends. Includes St George.
Source: Bloomberg

Graph 40
Banks' Liquid Assets
Domestic books, per cent of assets*



* Excludes non-resident assets
** Estimate for July 2009
Sources: APRA; RBA

Financial Markets' Assessment

Reflecting their ongoing strong performance and sound capital positions, the largest Australian banks continue to be highly rated. Australia's four largest banks are all rated AA by Standard & Poor's (S&P) and these ratings have been unchanged throughout the financial turmoil (Table 1).

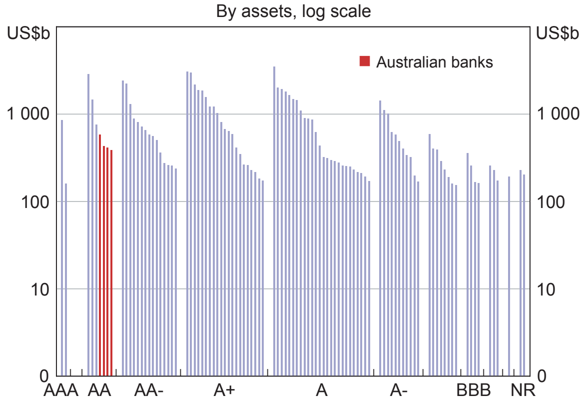
Table 1: Long-term Ratings of Australian Banks(a)
As at 22 September 2009

	Outlook	Current	Last change	
			Direction	Date
AMP Bank	Stable	A	↑	April 2008
ANZ Banking Group	Stable	AA	↑	February 2007
Arab Bank Australia	Stable	A-	--	January 2007
Bank of Queensland	Stable	BBB+	↑	April 2005
Bankwest	Stable	AA	↑	December 2008
Bendigo and Adelaide Bank	Stable	BBB+	↑	February 2005
Citigroup	Stable	A+	↓	December 2008
Commonwealth Bank of Australia	Stable	AA	↑	February 2007
Rural Bank	Stable	BBB	↑	August 2007
HSBC Bank Australia	Negative	AA	↑	July 2006
ING Bank (Australia)	Stable	A+	↓	September 2009
Macquarie Bank	Negative	A	--	November 1994
ME Bank	Negative	BBB	↑	August 2006
National Australia Bank	Stable	AA	↑	February 2007
Rabobank	Stable	AAA	↑	August 1998
St George Bank	Stable	AA	↑	November 2008
Suncorp-Metway	Stable	A	↓	January 2009
Westpac Banking Corporation	Stable	AA	↑	February 2007

(a) Includes all Australian-owned banks, and foreign-owned banks operating in Australia that have an issuer rating from Standard & Poor's

Source: Standard & Poor's

Graph 41
Credit Ratings of the Largest 100 Banking Groups*
By assets, log scale



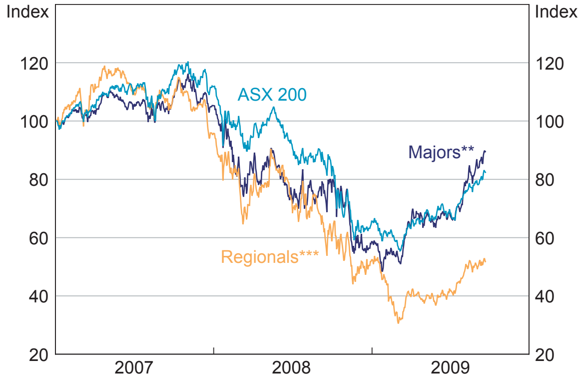
* Holding company ratings; predominantly Standard & Poor's local currency ratings, unless unrated, then Moody's senior unsecured
Sources: Moody's; Standard & Poor's; *The Banker*

In contrast, many large international banks have been downgraded over the past couple of years and, as a result, only five of the other largest 100 global banking groups have an equivalent or higher rating from S&P (Graph 41). S&P and Fitch recently reaffirmed their stable outlook for the major Australian banks' ratings, while Moody's has maintained the negative outlook that it assigned in March this year. The only Australian-owned bank to have been downgraded by S&P since mid 2008 is Suncorp-Metway, though several subsidiaries of foreign banks have been downgraded, in line with their parent ratings.

Equity markets have also taken a positive view of the Australian banks over the past six months, even when compared with the general improvement in market sentiment. The Australian banking index has risen by around 75 per cent since early March, compared with a 48 per cent gain in the broader market. While the recent rally has been broadly based across the banking sector, the regional banks' share prices remain around 50 per cent lower than they were in early 2007, with the major banks' 10 per cent lower (Graph 42). Throughout the crisis period, share prices of the major Australian banks were more resilient than their counterparts in other advanced economies. As market uncertainty has eased, volatility for both banks and the market as a whole has declined, after it rose to very high levels late last year. The daily movement in banks' share prices has averaged 1.8 per cent since March, compared to peaks of over 4 per cent late last year.

Graph 42
Banks' Share Prices*

End December 2006 = 100



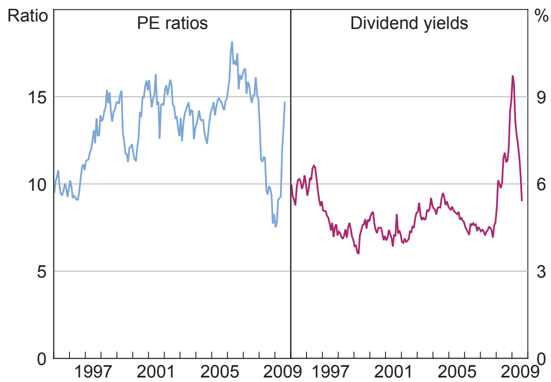
* Weighted by market capitalisation

** Includes St George

*** Bank of Queensland, Bendigo and Adelaide Bank and Suncorp-Metway

Sources: Bloomberg; RBA

Graph 43
Banks' PE Ratios and Dividend Yields



Source: Thomson Reuters

The increase in banks' share prices has led to a marked turnaround in market-based valuation measures. For instance, banks' forward price/earnings ratio is currently 14.7, which is around its long-run average and well above the low of 7½ that it reached in January (Graph 43). Similarly, banks' dividend yields have fallen to average around 5½ per cent, after peaking at just under 10 per cent in January, with this fall reflecting both higher share prices and lower dividends.

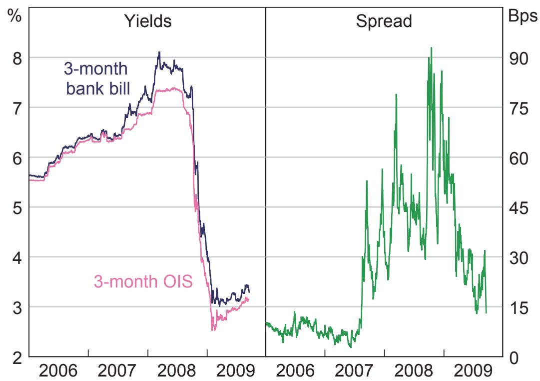
The firmer tone is also reflected in Australian banks' CDS premiums – the price paid by investors to insure debt – which have generally narrowed to levels prevailing prior to the collapse of Lehman Brothers. The cost of insuring the senior debt of the four major Australian banks is currently around 65 basis points per annum, compared to peaks of over 200 basis points earlier this year, but still well above the 5 to 10 basis points in the years preceding the financial turmoil.

Funding Conditions and Guarantee Arrangements

Funding conditions have improved considerably over the past six months as market sentiment has recovered from the extreme risk aversion of late 2008 and early 2009. As discussed in the previous *Review*, despite their relatively good performance, Australian banks were not immune from the acute uncertainty about the health of the global banking system that was precipitated by the collapse of Lehman Brothers in September last year. This uncertainty led to pressures on the cost and availability of funding, with capital market investors and some depositors showing signs of nervousness. In October 2008, the Australian Government responded to these developments by announcing that all deposits of $1 million or less in eligible ADIs would be automatically guaranteed by the Government under the Financial Claims Scheme, and that it was introducing a fee-based Guarantee Scheme for Large Deposits and Wholesale Funding. These measures were successful in assuaging investor unease, and funding conditions have improved steadily over the course of 2009 as risk aversion has abated. Banks have issued a large volume of long-term debt in domestic and offshore markets, increasingly without the backing of the Government's guarantee, and deposit growth remains firm. There have only been limited signs of improvement in the securitisation market for new issues relying solely on private investors, but developments in recent weeks have been positive.

Graph 44

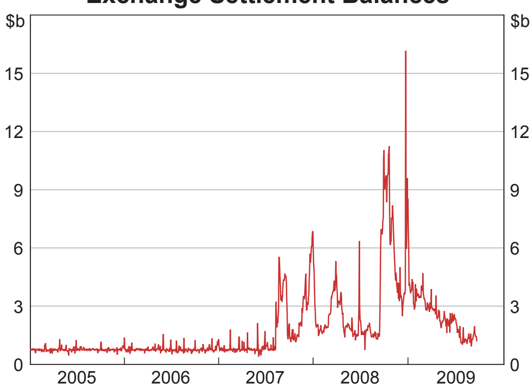
Short-term Interest Rates



Sources: RBA; Tullett Prebon (Australia) Pty Ltd

Graph 45

Exchange Settlement Balances



Source: RBA

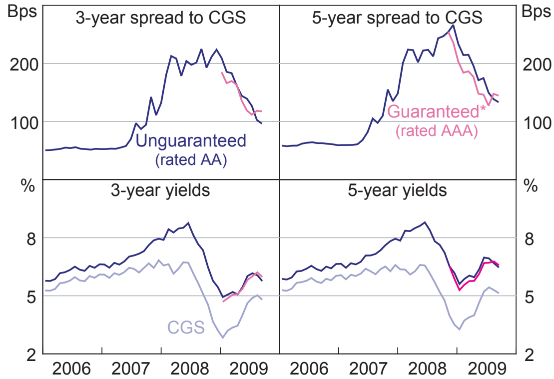
The recovery in sentiment over recent months has been evident in the domestic money market, with the spread between the yield on 3-month bank bills and the overnight index swap rate for the same maturity having narrowed to an average of around 20 basis points over the past couple of months, compared with the peaks of around 100 basis points at the height of the global market uncertainty in late 2008 (Graph 44). As this uncertainty has dissipated, the RBA has reduced the supply of Exchange Settlement (ES) balances, after these balances had been increased significantly to assist in the smooth functioning of markets. ES balances have averaged around $1½ billion since June, which is well below the peaks around the end of 2008 (Graph 45).

Spreads on long-term bank debt in domestic and offshore markets have also narrowed over the past six months or so, though they remain higher than prior to the onset of the market turmoil. For example, the spread between 3-year bonds issued domestically by AA-rated banks and Commonwealth Government Securities (CGS) is currently around 95 basis points, compared to a peak of 225 basis points in late 2008, and 55 basis points in mid 2007 (Graph 46). At this horizon, spreads on domestic unguaranteed debt have narrowed to the extent that it is now slightly cheaper for AA-rated banks to issue unguaranteed than guaranteed, after taking into account the guarantee fee. For these banks, the all-in costs of guaranteed and unguaranteed debt have also converged at longer horizons. It is still, however, relatively more expensive to issue unguaranteed for lower-rated institutions.

Since the guarantee arrangements for wholesale funding became operational on 28 November 2008, Australian banks have issued around $185 billion of long-term debt, with $142 billion of this having been issued under the Guarantee Scheme (Graph 47). Around 60 per cent of the bonds have been issued offshore, mainly in the US market. While demand for government guaranteed paper remains strong, banks have recently stepped up their issuance of unguaranteed debt, in both the Australian and overseas markets. In the domestic market, unguaranteed paper has accounted for around half of total issuance over the past few months, compared to 10 per cent in the March quarter 2009. Several banks have tapped offshore markets for unguaranteed debt in recent months, particularly for longer-dated maturities beyond the 5-year limit of the Guarantee Scheme.

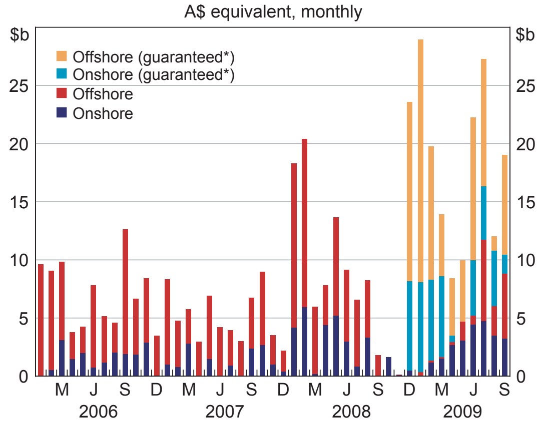
Banks have also used the Guarantee Scheme for short-term debt and large deposits (greater than $1 million), but investor appetite to pay for the guarantee for these liabilities has been lower than for term debt. In August 2009, the average value of outstanding short-term guaranteed debt was $17.2 billion, which is equivalent to roughly 5 per cent of total short-term debt outstanding (Graph 48). The majority of this had been issued by foreign-owned banks. Total guaranteed large deposits stood at just under $17 billion, only around 1½ per cent of total deposits. Both guaranteed short-term debt and large deposits have declined over the past six months.

Graph 46
Major Banks' Bond Pricing
A$ debt, monthly



* Includes fee for guaranteed issues
Sources: Bloomberg; RBA; Thomson Reuters; UBS AG, Australia Branch

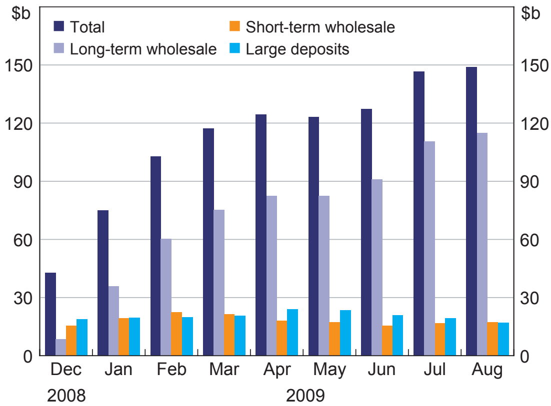
Graph 47
Banks' Bond Issuance
A$ equivalent, monthly



* Guaranteed by the Australian Government
Source: RBA

Graph 48

ADIs' Guaranteed Liabilities*

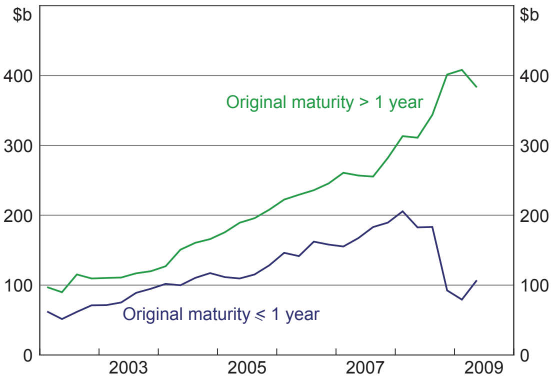


* Average daily values guaranteed under the Guarantee Scheme for Large Deposits and Wholesale Funding

Source: Government Guarantee Administrator

Graph 49

Banks' Non-intermediated Debt*



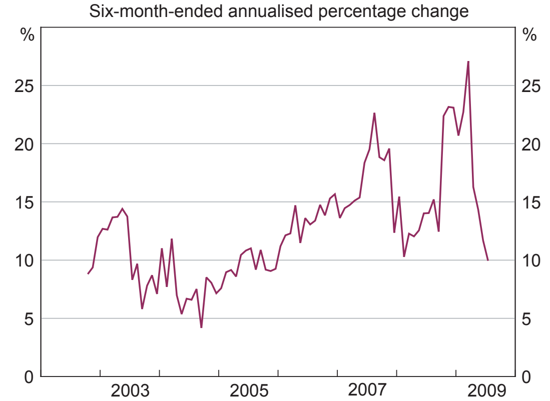
* Net of domestic interbank holdings

Source: APRA

Graph 50

ADI Deposits*

Six-month-ended annualised percentage change



* Seasonally adjusted and adjusted for changes in reporting. Excludes foreign currency and intra-group deposits and certificates of deposit.

Sources: APRA; RBA

More generally, the recent pattern of wholesale debt issuance is consistent with banks having lengthened the maturity profile of their liabilities, after they had shortened it in the early stages of the financial turmoil. As a result, the share of banks' outstanding debt with an original maturity greater than one year increased from 63 per cent to 78 per cent over the year to June 2009 (Graph 49). In recent months, the average tenor of new bond issues has been around 4½ years, and the average maturity of outstanding bonds has been broadly stable at just over 3 years.

Deposit growth for the ADI sector as a whole has been strong through the crisis period, though it has moderated over recent months as investor appetite for alternative assets has returned. Over the six months to July 2009, total deposits increased at an annualised rate of 10 per cent, compared to rates of around 25 per cent earlier this year (Graph 50). Most banks are endeavouring to increase their share of funding from deposits, in response to markets' increased focus on funding liquidity risk. For some of the smaller banks, it is also because of a lack of alternative funding options, given the difficulties in the securitisation market. These factors have led to strong competition for deposits, especially for term deposits, and deposit spreads have widened. For instance, the average rate paid by the major banks on their term deposit 'specials' is currently around 175 basis points above the 90-day bank bill rate, compared to about 75 basis points as at end December 2008.

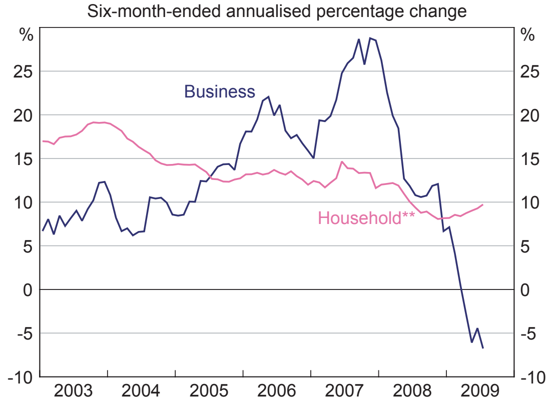
While banks have been able to tap capital markets and attract strong inflows of new deposits, conditions in the asset-backed commercial paper (ABCP) and residential mortgage-backed securities (RMBS) markets have been difficult. As discussed in detail in previous *Reviews*, ABCP markets around the world were the first to be affected by the repricing of risk. While they remain strained, there have been some signs of improvement in recent weeks. As at June 2009, the outstanding value of ABCP issued by Australian entities (on and offshore) was around $32 billion, 55 per cent lower than its peak in mid 2007. It is estimated that the spread on domestic ABCP over the bank bill rate is currently around 55 basis points, whereas it had been possible to issue ABCP at spreads of around 5 basis points before mid 2007.

Conditions in the RMBS market have also been quite difficult, though there have recently been signs of improvement and increased investor appetite. RMBS issuance had averaged just $2.7 billion per quarter since mid 2007, compared to a quarterly average of $15 billion over the previous two years. While most of the issuance that has taken place since October 2008 has been purchased by the Australian Office of Financial Management (AOFM), two recent RMBS issues were purchased entirely by private investors. Secondary market spreads have also narrowed over recent months, to around 150 to 250 basis points above the bank bill swap rate, compared with 350 to 550 basis points around the turn of the year, and 15 basis points before the onset of the financial turmoil. The narrowing spreads are consistent with the generally firmer tone in financial markets, and the ongoing good credit quality of Australian RMBS. Losses on prime Australian RMBS (after proceeds from property sales) have been very low throughout the crisis, averaging around 5 basis points per year. Moreover, these losses continue to be largely covered by credit enhancements such as lenders' mortgage insurance, and no losses have been borne by investors in a rated tranche of an Australian RMBS.

Lending Growth and Credit Conditions

Domestic credit growth has continued to moderate over the past six months, largely because demand for intermediated debt from businesses remains weak, and there has also been a general tightening in the terms and conditions under which credit is being extended. The tightening in credit standards has partly reflected a turnaround of the marked easing that took place in some areas in earlier years and is not an unexpected development at this stage of the economic cycle. Banks'

Graph 51
Bank Credit*
Six-month-ended annualised percentage change



* Seasonally adjusted and adjusted for some series breaks
** Including securitisation
Sources: APRA; RBA

appetite for risk may have declined, but they have good access to funding and credit remains available for good quality borrowers.

Bank business credit fell at an annualised rate of 6¾ per cent over the six months to July 2009, although the rate of decline has stabilised in more recent months (Graph 51). These outcomes follow the very strong growth in business credit over the second half of 2007, when access to capital markets dried up and companies increasingly turned to banks for funding. As discussed in more detail in the *Household and Business Balance Sheets* chapter, the recent moderation in business credit growth is consistent with weak demand for new borrowing and businesses paying down debt to reduce their leverage, as well as some corporates issuing debt in wholesale markets.

It is also consistent with an easing of the very strong competition that was evident in some areas of the business loan market in the middle years of this decade, which was associated with a narrowing of margins and a general easing in the availability of credit. More recently, banks have sought to increase their risk margins as well as strengthen non-price conditions such as collateral requirements and loan covenants. While it is difficult to generalise, the available evidence suggests that margins on new and refinanced corporate loans are at least 100 basis points higher than in mid 2008.

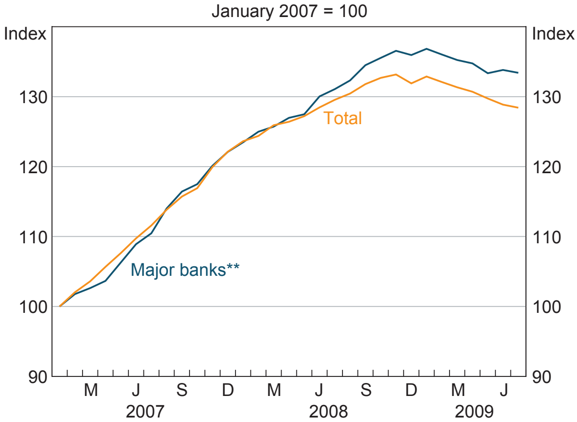
Indications are that loan conditions have been tightened more for larger companies than for their smaller counterparts. All industries appear to have experienced some tightening, but the commercial property sector has been especially affected, reflecting ongoing uncertainty about asset quality and property valuations. Tighter loan terms have not, however, generally prevented property companies from refinancing their debt as it falls due.

Bank business credit has turned down across all types of bank, but more so among the foreign-owned banks than others. The activities of these banks had been one of the factors underpinning the previous strong growth in business lending, especially in the large-value segment where they had made notable gains in market share.[1] Despite the recent slowing, however, there is little evidence of a generalised withdrawal from the Australian market and foreign-owned banks have continued to participate in recent syndicated loans. Lending by non-bank financial institutions has also contracted noticeably, partly because some foreign non-bank entities have pulled back from the domestic market. At the same time, credit extended by the major banks

Graph 52

Business Credit*

January 2007 = 100



* Seasonally adjusted and adjusted for some series breaks
** Includes St George, and Bankwest from January 2009
Sources: APRA; RBA

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

has fallen by less than total business credit, and their lending to unincorporated businesses has continued to grow (Graph 52).

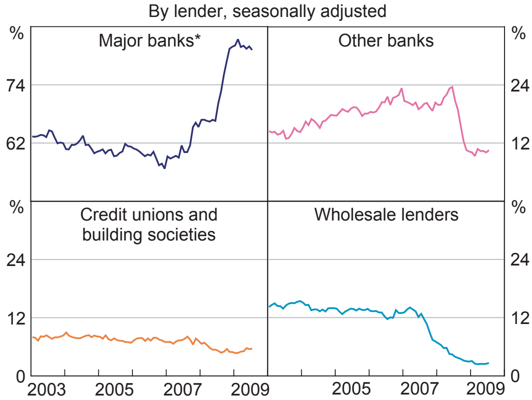
In contrast to business credit, bank household credit growth has strengthened recently, to an annualised rate of 10 per cent over the six months to July 2009, compared to 8 per cent over the six months to January. Although many households are taking a more cautious approach to their finances than in recent years, first-home buyers' appetite for borrowing has been strong: they accounted for 28 per cent of new housing loan approvals over the six months to July 2009, compared to an average of 16 per cent over the five years to December 2008. This demand has, however, been starting to ease somewhat.

While housing credit growth has firmed, lending standards have continued to tighten a little and banks are paying close attention to credit risk. Many banks have lowered their maximum loan-to-valuation ratios (LVRs) further over the past six months, with most of the largest lenders no longer offering loans with LVRs greater than 90 per cent to new customers. Most lenders have also announced higher 'genuine savings' requirements (not including the first-home owner grant), often to a minimum of 5 per cent.

Graph 53

Share of Owner-occupier Loan Approvals

By lender, seasonally adjusted



* Includes St George, and Bankwest from January 2009

Sources: ABS; APRA; RBA

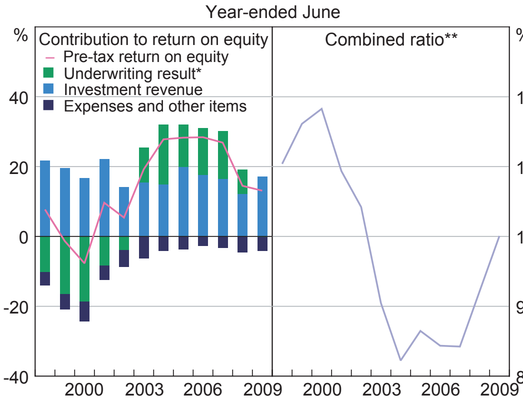
Recent developments in the mortgage market have occurred against a backdrop of significant changes in market shares. Most of the new lending over the past year or so has been by the major banks, which have increased their share of new owner-occupier loan approvals to 81 per cent as at July 2009, from around 60 per cent in mid 2007 (Graph 53). In contrast, lenders that had previously relied on securitisation for funding have lost market share, with the share of approvals accounted for by mortgage originators falling to around 2½ per cent in July, compared to around 12 per cent in mid 2007. The smaller banks and, to a lesser extent, credit unions and building societies have also lost market share. These movements follow a lengthy period when the major banks had been losing market share as securitisation markets expanded.

General Insurance

The Australian general insurance industry recorded solid profits over the latest financial year, despite facing a challenging operating environment. Total pre-tax profit was $3.6 billion in the year to June 2009, which was around 4 per cent lower than in the previous year. The industry's

Graph 54

Performance of General Insurers



* Premium revenue (net of reinsurance expenses) minus claims and underwriting expenses

** Claims and underwriting expenses as a per cent of premium revenue (net of reinsurance expenses)

Source: APRA

pre-tax return on equity was around 13 per cent over the same period, compared to a 10-year average of around 17 per cent (Graph 54).

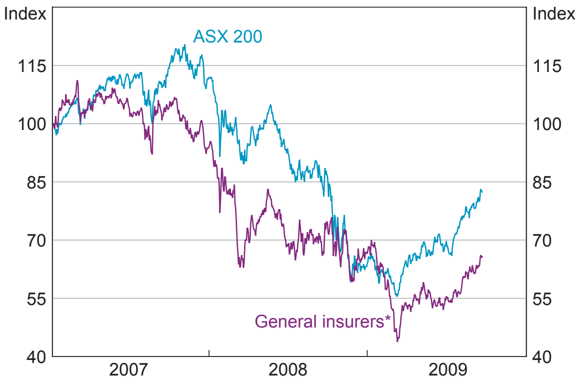
Profits were derived from returns on invested premiums, with investment income increasing by 50 per cent, to $4.7 billion, over the year to June 2009. The industry benefited most from higher prices of fixed-income securities, which account for around two thirds of their financial assets. At the same time, Australian general insurers were relatively insulated from the sharp falls in equity markets in late 2008 and early 2009, because direct holdings of equities accounted for only around 5 per cent of their financial assets in mid 2008.

In contrast to the improved investment performance, underwriting conditions remain difficult. Total claims incurred by Australian insurers (net of reinsurance and other recoveries) increased by 21 per cent over the year to June 2009, which is well above the average annual rise of 9 per cent over the previous five years. The factors that contributed to this outcome included: a number of significant 'natural hazard' events, most notably the Victorian bushfires; a rise in the size and frequency of small claim events across a number of business lines; and higher measured claim liabilities arising from the reduction in risk-free rates (which are used to discount expected future claim payments). These higher claims were only partly offset by stronger growth in net premium revenue, which rose by 6½ per cent over the same period, compared with an average annual rise of around 3 per cent over the previous five years. This pick-up was due to an increase in premium rates for some business lines, as well as a decline in reinsurance expenses. A summary measure of the industry's underwriting performance is the combined ratio – claims and underwriting expenses relative to net premium revenue – which rose by 8 percentage points over the year to June 2009, to around 100 per cent. This is the weakest result since 2001/02 and indicates that, in aggregate, insurers roughly broke even on their underwriting business.

Despite the recent pressures on their underwriting operations, the Australian general insurance industry remains well capitalised, with the industry holding capital equivalent to around 1.8 times the regulatory minimum as at March 2009 (the latest available aggregate data). Several of the large Australian insurers have recently sought to further strengthen their capital position, and have raised around $1.9 billion of equity so far in 2009.

As discussed in previous *Reviews*, the lenders' mortgage insurance (LMI) segment of the global insurance industry has attracted particular attention because of the pressures arising from developments in global housing markets. LMI provides protection for lenders against borrower default, and is also a form of credit enhancement in the RMBS market. In the United States, for example, LMIs have continued to report large losses due to the very weak US housing market. In contrast, the two largest LMIs in Australia, QBE and Genworth, have continued to report solid profits, despite claims rising from a low base. Consistent with developments in the banking sector, the Australian LMIs have also tightened their underwriting standards: they have increased their premiums for loans with higher loan-to-valuation ratios, as well as introduced 'genuine savings' requirements and lowered maximum LVRs for loans that they are willing to cover.

Graph 55
General Insurers' Share Prices
End December 2006 = 100



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

More generally, analysts anticipate that listed insurers' profits will rise somewhat over the next financial year, partly because of higher average premium rates across some business lines as insurers respond to the higher claims rates of recent years. This more positive outlook has been reflected in insurers' share prices, which have risen by around 25 per cent since March, to be back around the levels of late 2008 (Graph 55). While share prices remain around 40 per cent lower than their peak in February 2007, this compares to around 60 per cent and 50 per cent for the US and European insurance indices. In contrast to many of their international peers, the four largest Australian insurers have also maintained high credit ratings throughout the financial turmoil: all of them are rated A+ or higher by Standard & Poor's and are on stable outlooks (Table 2).

Table 2: Financial Strength Ratings of Selected Large Insurers
As at 22 September 2009

	Current	Outlook
Allianz Australia Insurance	AA-	Stable
Insurance Australia Group	AA-	Stable
QBE Insurance Australia	A+	Stable
Suncorp-Metway Insurance	A+	Stable

Source: Standard & Poor's

Managed Funds

The turbulence in financial markets over the past couple of years has greatly affected the performance of the funds management industry, though there have been signs of improvement more recently. On a consolidated basis, the industry's assets under management increased at an annualised rate of around 4 per cent over the six months to June 2009, but are still 13 per cent lower than the peak in September 2007 (Table 3). The recent rise has been due to the stronger performance of superannuation funds, which account for over 60 per cent of total assets under management.

Table 3: Funds under Management
Consolidated, June 2009

	Level	Share of total	Six-month-ended annualised percentage change: Dec 2008	Six-month-ended annualised percentage change: Jun 2009
	$b	Per cent	Per cent	Per cent
Superannuation funds	739.8	61.3	-19.8	10.9
Life insurers[(a)]	162.7	13.5	-18.8	-2.6
Public unit trusts	249.2	20.7	-13.9	-5.1
Other managed funds[(b)]	54.7	4.5	-12.3	-14.2
Total	**1 206.4**	**100.0**	**-18.0**	**4.1**
Of which:				
All superannuation assets[(c)]	882.3	73.1	-19.9	8.4

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

Superannuation Funds

According to ABS data, superannuation funds' (consolidated) assets under management increased at an annualised rate of around 11 per cent over the six months to June 2009, following an annualised fall of 20 per cent over the second half of 2008. This turnaround has been due to stronger growth across most domestic asset classes, especially equity holdings which have increased in value over recent months as the share market has rallied (Table 4).

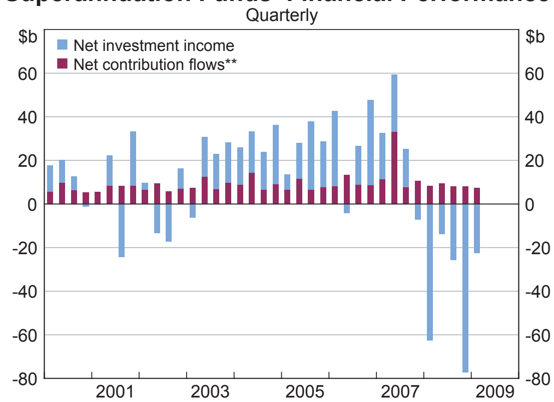
Table 4: Superannuation Funds' Assets
Unconsolidated[(a)], June 2009

	Level	Share of total	Six-month-ended annualised percentage change: Dec 2008	Six-month-ended annualised percentage change: Jun 2009
	$b	Per cent	Per cent	Per cent
Cash and deposits	163.4	18.3	19.0	22.1
Loans and placements	8.6	1.0	5.7	17.4
Short-term securities	44.4	5.0	6.0	23.5
Long-term securities	49.2	5.5	-17.1	5.8
Equities	258.2	29.0	-40.6	24.0
Units in trusts	130.2	14.6	-26.9	18.3
Other assets in Australia[(b)]	92.0	10.3	-0.5	14.6
Assets overseas	145.5	16.3	-21.3	-17.7
Total	**891.4**	**100.0**	**-20.3**	**12.2**

(a) Not adjusted for cross-investments with other managed fund sectors
(b) Includes non-financial assets
Source: ABS

The recent rise in funds under management follows a prolonged period of declining asset valuations. The latest available APRA data on industry returns show that superannuation funds recorded losses on their investment portfolios of about $140 billion over the year to March 2009, compared to an average yearly gain of around $65 billion over the five years to mid 2007 (Graph 56). Since the onset of the market turmoil, inflows of new funds into superannuation have also generally been slightly lower than in prior years, as some investors became more wary of market-linked assets. While aggregate figures for the June quarter 2009 are not yet available, industry data suggest that inflows have picked up. This likely reflects improved sentiment, as well as a temporary boost ahead of changes to superannuation rules that became effective on 1 July 2009, such as the reduction in the concessional contribution cap – the maximum amount that individuals can contribute to superannuation at the concessional tax rate.

Graph 56
Superannuation Funds' Financial Performance*

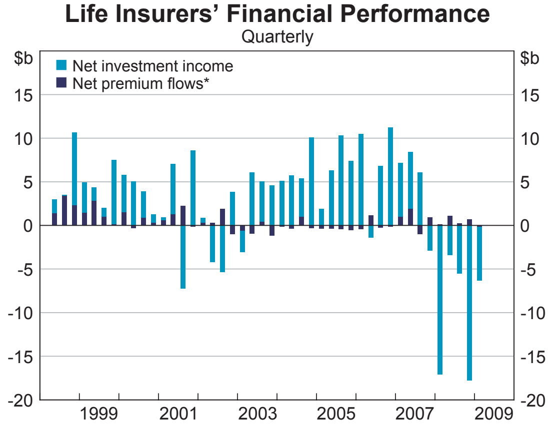


* From December 2004, data cover entities with at least $50 million in assets
** Total contributions received by funds plus net rollovers minus benefit payments
Source: APRA

Life Insurers

Life insurers (consolidated) assets fell by $20 billion, or 11 per cent, over the year to June 2009, with the majority of this occurring in the second half of 2008. Much of this decline has been due to lower valuations on superannuation assets held in life offices, which account for around 90 per cent of the industry's total assets. APRA figures show that life insurers recorded investment losses of around $33 billion over the year to March 2009 (the latest data available), compared to average annual net income of around $20 billion over the five years to mid 2007 (Graph 57). In turn, this outcome is consistent with the falls in share prices over the past couple of years, because life insurers held around three quarters of their assets in domestic equities and units in trusts at the end of 2007. Most of these investment losses were, however, borne by policy holders rather than the life insurers themselves, and the industry reported aggregate profits of $1.4 billion over the year to March 2009. While prospects for the life insurance industry remain closely tied to those for the superannuation

Graph 57
Life Insurers' Financial Performance



* Total premiums received minus policy payments
Source: APRA

sector, there are also indications that demand for traditional life insurance products has strengthened recently.

Public Unit Trusts and Other Managed Funds

Outside of superannuation funds and life offices, the majority of assets under management are invested with public unit trusts. These entities have also been significantly affected by the recent financial turbulence, and their (consolidated) assets fell by 10 per cent over the year to June 2009. Asset values have declined across all of the main types of public unit trusts, as the prices of most asset classes have fallen since the onset of the market turmoil (Table 5).

Table 5: Public Unit Trusts' Assets
Unconsolidated[(a)], June 2009

	Level	Share of total	Six-month-ended annualised percentage change: Dec 2008	Six-month-ended annualised percentage change: Jun 2009
	$b	Per cent	Per cent	Per cent
Listed property trusts	122.9	44.5	0.5	-4.1
Listed equity trusts	49.0	17.7	-4.2	-10.3
Unlisted equity trusts	75.9	27.5	-37.4	-1.1
Other trusts	28.5	10.3	-20.9	-8.2
Total	**276.4**	**100.0**	**-15.4**	**-4.9**

(a) Not adjusted for cross-investments with other managed fund sectors
Source: ABS

As discussed in the previous *Review*, one sector that has been particularly affected by recent developments is the mortgage trust industry. Many of these trusts experienced outflows of funds in 2008, and most responded by suspending redemptions because of the illiquidity of their underlying assets. Following this, ASIC introduced provisions allowing investors to withdraw funds based on hardship grounds, such as if they would be unable to meet immediate living or medical expenses. As at mid August 2009, frozen mortgage trusts had paid out around $38 million to investors under these provisions. ASIC has also recently relaxed these hardship provisions by increasing the annual withdrawal limit for investors, permitting more frequent withdrawals by investors, and allowing a wider range of investors to access funds.

Market Infrastructure

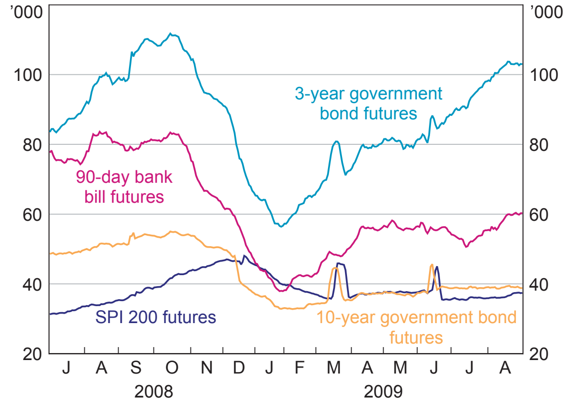
As conditions in financial markets have stabilised in recent months, there has been some recovery in activity in Australia's cash equity and derivatives markets. With lower volatility and reduced counterparty credit concerns, the central counterparties supporting Australia's financial markets have also been able to reverse the sharp increases in margin levels implemented in late 2008, and reduce the intensity of their participant-monitoring activities. Settlement of high-value payments and securities trades has continued to proceed smoothly.

Having declined sharply during the period of market turbulence in late 2008 and early 2009, the volume and value of trades executed in the Australian cash equity market increased by

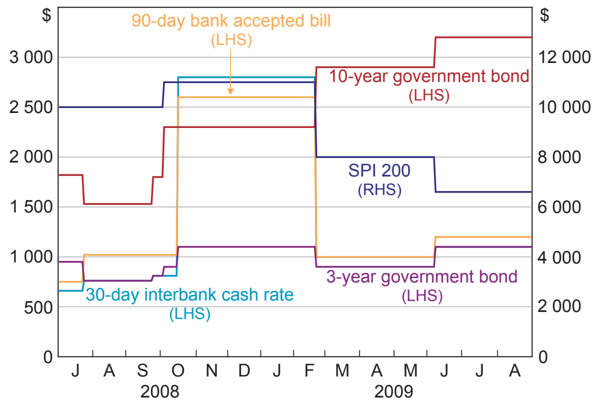
20 per cent and 30 per cent in the June quarter 2009. The removal of the ban on short selling of financial stocks in late May might also have contributed to some recovery in activity. Over the financial year as a whole, however, the average daily value of trades in the cash equity market fell by more than 30 per cent, largely reflecting the decline in share prices over the year.

Turnover also recovered on the Sydney Futures Exchange (SFE) during the first half of the year, at least for the major interest rate contracts. For example, after an unusually large fall of more than 40 per cent in the final quarter of 2008, average daily turnover in the 90-day bank bill futures contract rose by 21 per cent in the first quarter of 2009 (Graph 58). Turnover in the 3-year government bond futures contract rose by 19 per cent in the first quarter and continued to rise through to end July. There was also a modest rebuilding of open positions across a number of contracts late in the financial year.

Graph 58
Turnover in Major SFE Contracts
65-day moving average

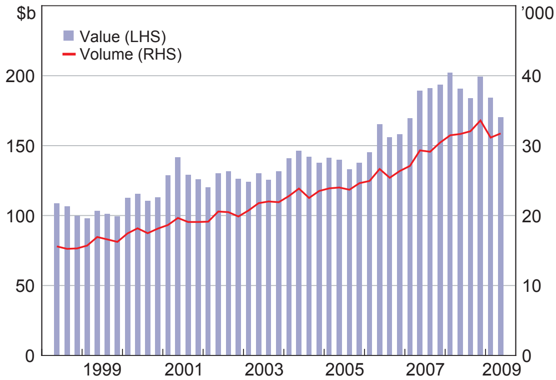


Graph 59
SFE Futures Initial Margins
Per contract



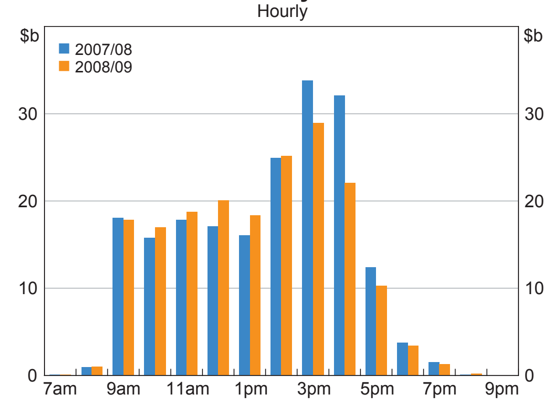
Despite the recovery in activity, the scale of risk exposure assumed by the central counterparties supporting the equities and futures markets has declined. One measure of risk exposure is the value of margin held by the central counterparties in respect of participants' positions. Both central counterparties increased initial margin levels sharply late in 2008, as market volatility increased (Graph 59). In most cases, these increases have been reversed more recently, leading to a sharp decline in total margin held by both central counterparties. Initial margin held by SFE Clearing Corporation declined from a peak of $5.7 billion in December 2008 to $2.4 billion at end-June, while total initial and mark-to-market margin held by the Australian Clearing House peaked at $2.1 billion in February 2009, before declining to $1.2 billion at end-June. The frequency of intraday margin calls was also much lower during the first half of 2009, again reflecting lower market volatility. Also, as counterparty credit risks receded, the central counterparties upgraded several participants within their internal credit-rating framework and removed a number of participants from their 'watch list' for more intensive monitoring.

Graph 60
RITS Daily Value and Volume
Daily average



Source: RBA

Graph 61
Settled Payments
Hourly



Source: RBA

Settlement has proceeded smoothly in the cash equity market in recent months, with some evidence that new arrangements to deal with settlement fails improved settlement performance. As recommended in the Reserve Bank's *Review of Settlement Practices for Australian Equities* in May 2008, ASX increased the penalty fee for failed settlements in September 2008, and in March 2009 introduced a regime requiring that any trades remaining unsettled on the fifth day after trade date be closed out. The rate of settlement fails had already begun to decline in anticipation of these measures, and has averaged less than 0.1 per cent since the end of March.

While there has been some recovery in market activity in recent months, the value of settlement activity in Australia's high-value payment system, RITS, remains significantly below levels seen prior to the market turbulence (Graph 60). The average daily value of settled payments during the June quarter 2009 was $170 billion, down by 16 per cent from its peak in the March quarter 2008. RITS is used to settle both 'clean' payments and fixed-income securities transactions submitted via Austraclear. Much of the recent decline in settlement values is associated with clean payments, and is consistent with the downturn in foreign exchange market activity over the same period. In contrast, the average daily volume of payments settled through RITS has tended to increase over the same period, due mainly to continued growth in the number of lower-value payments settled in the system.

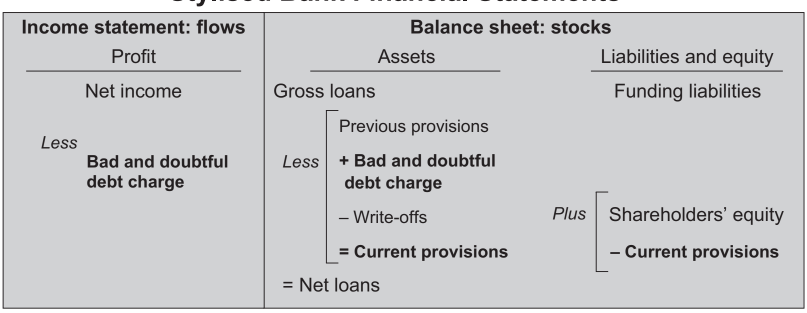
Despite earlier concerns that credit issues might spill over to payment settlements activity, this critical part of financial market infrastructure has continued to function efficiently. In particular, greater liquidity held in the form of Exchange Settlement account balances has enabled some settlements to be brought forward during the day. As a result of this and the decline in values, the typical peak in settlement activity that occurs late in the day has moderated somewhat (Graph 61). Moreover, there has been no indication of any unusual settlement activity or operational dysfunction, such as might cause an increase in the number of extensions to RITS operating hours or require greater recourse to the Reserve Bank's overnight repo facility.

Box A: Banks' Provisioning

Recently, banks around the world have markedly increased the provisions that they hold against losses incurred in their loan portfolios. There are two broad types of provision, both of which have risen since the onset of the financial turmoil. The first is 'individual' provisions that are established when a bank identifies a specific loan as being 'impaired', in that it is unlikely to be repaid in full and the value of collateral is not expected to be enough to cover the outstanding amount. The second type is 'collective' provisions that are held against currently unidentified losses on portfolios of loans with similar risk characteristics, and against a general deterioration in the loan book. These are based on factors such as historical loss experience and prevailing economic conditions.

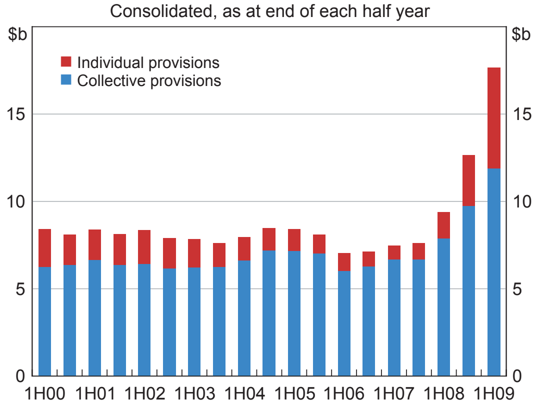
Banks' provisioning affects their profits as well as their balance sheets and capital positions. The impact on profits occurs when a bank changes either type of its provisions. New provisions are raised through a 'charge for bad and doubtful debts', which is recorded as an expense in the income statement and therefore reduces profits (Figure A1). These charges are added to the stock of outstanding provisions that are held on the balance sheet which, in turn, are subtracted from the value of outstanding loans, and from the retained earnings component of shareholders' equity. The stock of provisions is also affected by other factors, such as the value of loans that are 'written off' after the bank deems them to be unrecoverable.

Figure A1
Stylised Bank Financial Statements



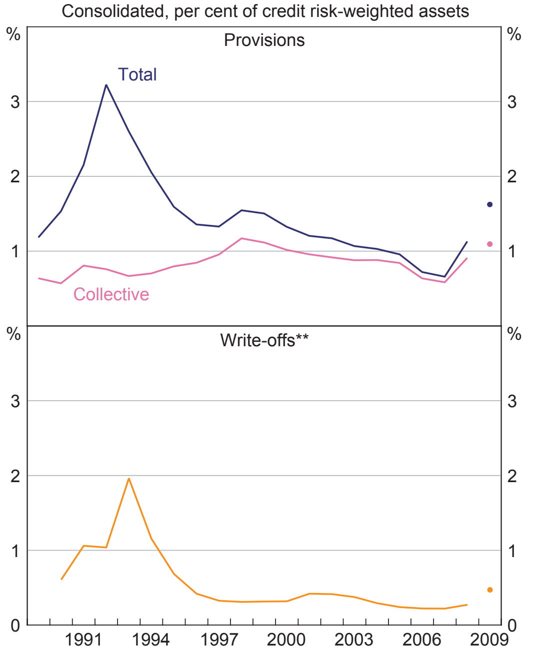
While the Australian financial system has performed better than many others throughout the financial turmoil, the domestic banks have still had to increase their provisions, against both their domestic and overseas loan books. For the four major banks, total provisions stood at $17.7 billion as at their latest reporting dates (end March 2009 for three of these banks and end June for the other), compared to $9.4 billion a year earlier (Graph A1). Around half of the increase was in individual provisions, which rose to $5.8 billion as at the latest half year. The available evidence suggests that only around 7 per cent of these relate to residential mortgages,

Graph A1
Major Banks' Provisions
Consolidated, as at end of each half year



* First half figures are half year to June for CBA and half year to March for ANZ, NAB and Westpac. Includes St George, and Bankwest from second half of 2008. From 2006 data are on an IFRS basis; prior years are on an AGAAP basis.
Sources: Banks' annual and interim reports

Graph A2
Major Banks' Provisions and Write-offs*
Consolidated, per cent of credit risk-weighted assets



* 2009 observation is calculated based on June 2009 figures for CBA and March 2009 figures for ANZ, NAB and Westpac. Includes St George and Bankwest in 2009.
** Per cent of average credit risk-weighted assets. 2009 write-offs for ANZ, NAB and Westpac are annualised first half to March figures.
Sources: APRA; RBA; banks' annual and interim reports

despite mortgages accounting for about 60 per cent of total (consolidated) lending. The rise in individual provisions against business loans was partly the result of the difficulties experienced by a small number of companies with complicated and/or highly leveraged business models that proved to be unsustainable when financial conditions deteriorated. It has also been due to a recent more-widespread rise in the number of businesses experiencing repayment difficulties as the economy has slowed.

There has been a similar-sized rise in collective provisions over the past year, which the major banks have largely attributed to weaker economic conditions in Australia and abroad. In this environment, the value of some types of collateral has declined and banks have lowered some of the internal credit ratings that they assign to customers, which has resulted in affected loans moving into pools with higher provisioning rates. As at the latest half year, the major banks' outstanding collective provisions stood at $11.9 billion.

These recent developments have seen the ratio of total provisions to credit risk-weighted assets – a measure of provisioning coverage that adjusts for changes in the risk profile of banks' lending – rise to 1.6 per cent, compared to a low of around 0.7 per cent in 2007 (Graph A2). This is, however, still much lower than the ratio of 3.2 per cent recorded in the early 1990s recession when banks experienced a significant fall in the quality of their business loans, especially in the commercial property sector. In contrast to the current cycle in provisioning, almost all of the rise in the early 1990s was due to provisions against individual exposures. The ratio of write-offs to credit risk-weighted assets has also risen much less than in the early 1990s, to around 0.5 per cent compared with 2 per cent in 1993.

The increase in Australian banks' provisioning ratios over the past couple of years follows a prolonged period over which these ratios generally drifted downward. There were several reasons for this, including the strong performance of the Australian economy and the associated low levels of bad debts. It was also partly due to the introduction of Australian equivalents to International Financial Reporting Standards (IFRS) in 2005, which allowed banks to significantly reduce collective – previously termed 'general' – provisions from what they would have been under the previous accounting standards.[1] Under IFRS, provisions may only be set aside if there is objective evidence of an incurred loss on a loan. Although this approach has increased the transparency of financial reports by constraining firms' scope to use provisioning to smooth profits, it has restricted banks' ability to provision for losses that are expected over the life of the loan but not certain to occur. APRA has therefore sought to promote a more prudent and forward-looking approach to regulatory provisioning and introduced a new 'General Reserve for Credit Losses' that covers both expected and incurred losses, as part of the transition to IFRS.[2]

More generally, developments in provisioning ratios over the past decade or so are consistent with the procyclicality inherent in financial systems, especially when short-run changes in economic conditions affect profits or required capital. That is, there is often a tendency for both borrowers and lenders to take an optimistic view of risk during the 'good times', rightly or wrongly, and to quickly change their assessment when conditions turn for the worse.

As mentioned in the *Developments in the Financial System Architecture* chapter, there has been considerable international discussion about ways to dampen this procyclicality and to ensure that banks build up appropriate buffers against losses during the good times when loan portfolios are performing well. One approach, a form of which is already in place in Spain, is 'dynamic provisioning'. This is a rule-based model that requires banks' collective provisions to be increased during periods of below-average loan losses, or run down during periods of above-average loan losses, to ensure overall provisioning remains in line with the long-term average loss experience. Movements in collective provisions would therefore be countercyclical and dampen the tendency for profits to move with the credit cycle. Another proposal, which is currently being considered by the Basel Committee on Banking Supervision, is to base provisioning on 'expected', rather than only incurred, losses. This model would take factors that affect future losses into account and therefore make provisioning more forward looking. These factors could include expectations of future, not just current, economic conditions and developments in lending standards over the credit cycle.

1 *The reduction from the previous accounting standards, Australian Generally Accepted Accounting Principles (AGAAP), is estimated to have been around 20 per cent for the major banks. See Reserve Bank of Australia (2006), Box A: International Financial Reporting Standards,* Financial Stability Review, *September.*

2 *See Byres, W (2009), 'Some Australian Perspectives on Procyclicality', presentation to the 9th Annual International Seminar on Policy Challenges for the Financial Sector, Washington, D.C., 3–5 June.*

Household and Business Balance Sheets

Developments in financial markets and the macroeconomy since 2007 have seen the Australian household sector experience a sharp fall in net worth and a rise in unemployment, though in a number of respects, conditions have recently begun to improve. Policy measures have helped to support household finances, thereby limiting the increase in household financial distress, and confidence has increased in recent months.

As with households, the business sector has faced a challenging economic environment since 2007, though signs of improving conditions are emerging. Difficulties in credit markets appear to be easing somewhat, and funds have generally been available for good quality borrowers. Borrowing conditions, however, remain tighter than in recent years. While financial stresses have increased in some areas, particularly for commercial property, firms across the business sector have actively consolidated their balance sheets over the past six months. Listed companies have been able to raise a record amount of equity capital; investors have supported this issuance, as share prices have recovered somewhat and confidence about business prospects has improved.

Household Sector

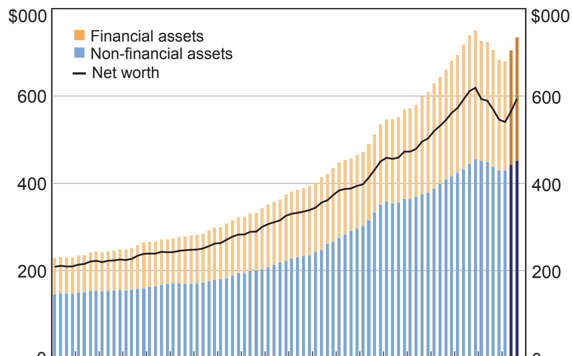
In the period since 2007, the household sector has experienced a significant decline, followed by a partial recovery, in net worth (Graph 62). The decline was largely driven by falls in the value of share portfolios: the ASX 200 price index is still around 30 per cent below its November 2007 peak. There had also been some softening in nationwide dwelling prices during 2008, though this price decline has since been retraced. Overall, preliminary estimates suggest that more than half of the peak-to-trough contraction in the household sector's net worth has been reversed over recent months.

At the same time as the negative effects of earlier asset price falls have been unwinding, household sector finances have benefited from various policy stimulus measures. Monetary policy has been eased substantially since late 2008, which has greatly reduced the ratio of interest payments to disposable income, from over 15 per cent in

Graph 62

Household Assets and Net Worth*

Per household

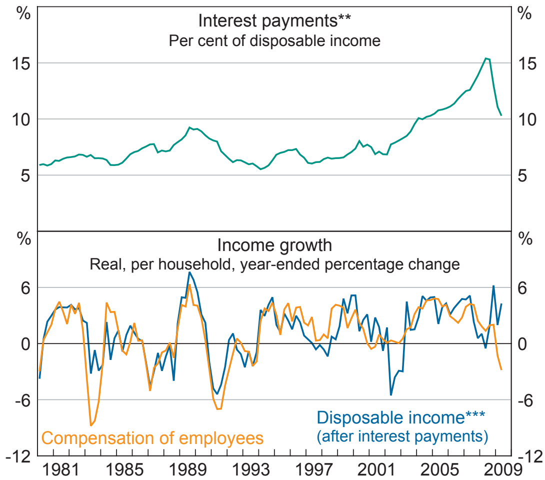


* Estimates for June quarter and September quarter 2009

Sources: ABS; RBA

Graph 63

Household Interest Payments and Income Growth*



* Household sector excluding unincorporated enterprises

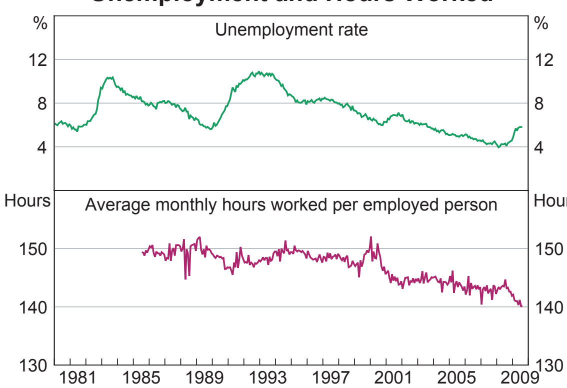
** Includes the imputed financial intermediation service charge; income is after tax and before the deduction of interest payments

*** Data are smoothed using a two-quarter moving average between March 2000 and March 2002

Sources: ABS; RBA

Graph 64

Unemployment and Hours Worked



Source: ABS

June 2008 to around 10 per cent at present (Graph 63). While the household sector's interest payment burden remains fairly high by historical standards, this reduction has been more rapid than in the early 1990s, and has substantially boosted household disposable income. Further supporting disposable income have been tax cuts and other government economic stimulus efforts, in the form of one-off payments to households: average real disposable income per household increased by 4 per cent over the year to the June quarter 2009. The support of these measures has helped offset the effect of the economic downturn on wage income – typically the main driver of household incomes. Compensation of employees per household declined 3 per cent in real terms over the year to the June quarter, reflecting the combination of a higher unemployment rate, slowing wage growth, and declines in employee working hours (Graph 64).

Although financial conditions have stabilised recently, for some households the effects of earlier developments have been relatively severe. The declines in equity values have had a larger effect on the assets of wealthier households and retirees: based on HILDA survey data, direct and indirect equity holdings comprise over 20 per cent of total assets for these households, compared to an average of 12 per cent for households outside these groups. Retirees' incomes have also been reduced by declining dividend and interest receipts. For many wealthier households, balance sheets have been further affected by the greater-than-average declines in prices of homes in the most expensive suburbs, which in the June quarter remained around 6½ per cent below their early 2008 peak. However, wealthier households tend to have lower gearing than average, limiting the sensitivity of their overall financial position to these asset price declines.

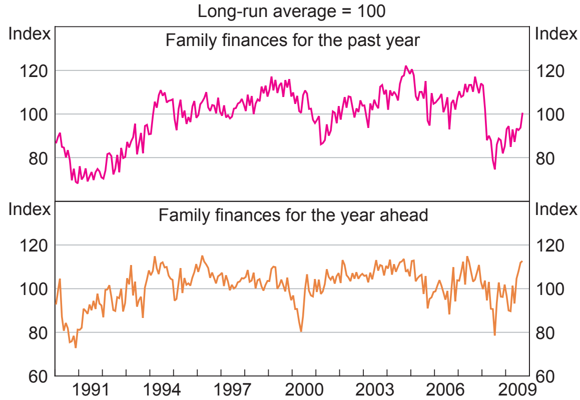
As asset values fell and economic conditions weakened, households' sentiment regarding their current circumstances deteriorated significantly (Graph 65). But both sentiment and confidence about the year ahead have rebounded in recent months, consistent with the more positive developments in housing and financial markets, the boosts to incomes households have experienced, and other signs of an improving economic outlook. This has seen some winding back of the very conservative financial attitudes of earlier in the year: while households still nominate deposits and debt repayment as the wisest options for savings, more recently interest in equities and property has picked up somewhat (Graph 66).

Households reduced the growth of their indebtedness significantly during 2008, though this has subsequently picked up. The reduced appetite for debt has been most pronounced for investment purposes. Over the six months to July 2009, borrowing for investor housing barely grew and margin loans continued to fall, though at a more moderate pace than earlier in the year (Graph 67). Households' use of credit cards has also been cautious, with little change in aggregate balances over the past six months (Graph 68). Overall, however, growth in household debt has edged up since the start of the year, supported by a pick-up in borrowing demand by owner-occupiers. Over the six months to July, owner-occupier housing

Graph 65

Consumer Sentiment

Long-run average = 100

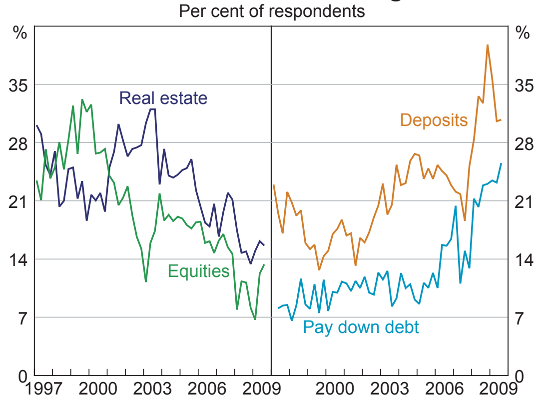


Source: Melbourne Institute and Westpac

Graph 66

Wisest Place for Savings

Per cent of respondents

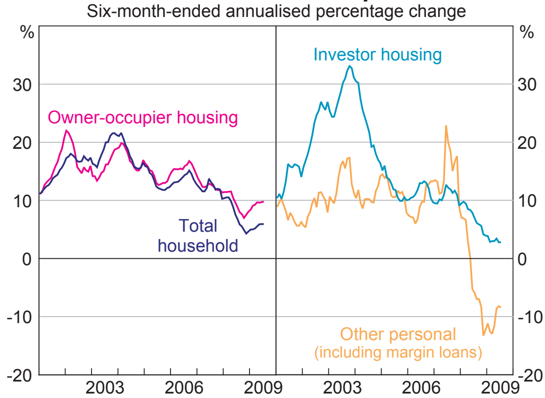


Source: Melbourne Institute and Westpac

Graph 67

Household Credit Components

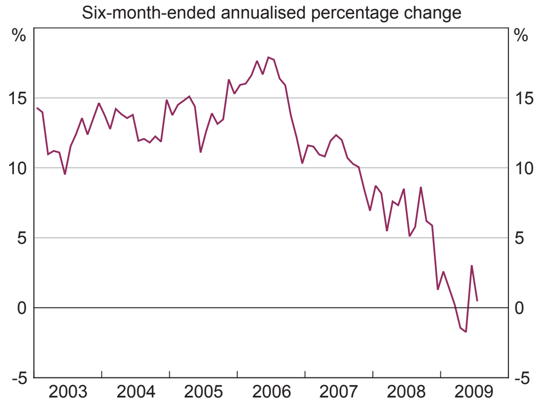
Six-month-ended annualised percentage change



Source: RBA

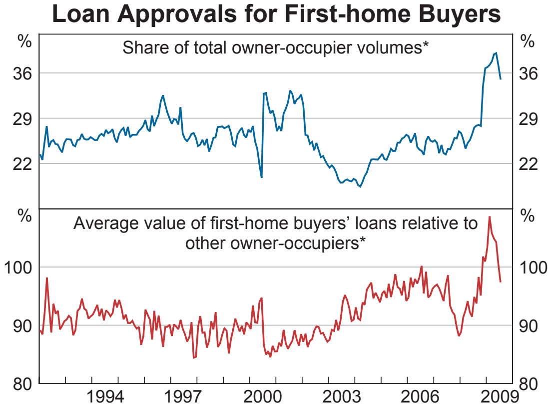
Graph 68

Credit Card Balances



Graph 69

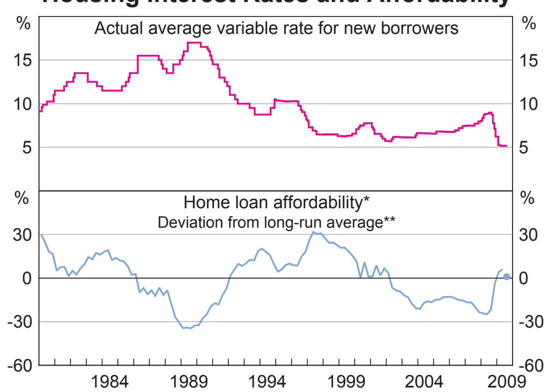
Loan Approvals for First-home Buyers



* Owner-occupier loan approvals net of refinancing
Sources: ABS; RBA

Graph 70

Housing Interest Rates and Affordability



* Index constructed as the ratio of average household disposable income to the required monthly repayment for the median-priced home (houses and apartments) financed with a 25-year loan assuming an 80 per cent LVR at the full-doc prime mortgage rate.
** Average since 1980 to present; estimate for September quarter 2009.
Sources: ABS; RBA; REIA

credit grew at an annualised rate of 9.8 per cent, up from 8.4 per cent in January 2009.

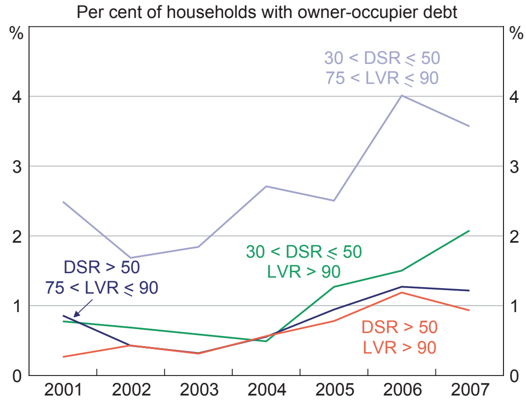
A significant driver of owner-occupier housing loan demand has been first-home buyers looking to take advantage of recently enhanced government grants. Since late 2008 first-home buyers' share of total owner-occupier loan approvals, currently at 35 per cent, has been around 10 percentage points higher than its average over the previous 15 years (Graph 69). On top of the large increase in the volume of first-home buyer loans, the average value of these loans has moved sharply higher since late 2008, and indeed has exceeded that of other owner-occupier loans in some months – an unusual outcome by historical standards, in that first-home buyers' loans have traditionally been smaller than those of other home buyers. More recently, there are signs that first-home buyer demand has eased.

Loan demand by both first-home buyers and established owner-occupiers has also been supported by a substantial lowering in borrowing costs. Reflecting the significant cash rate reductions over the past 12 months, variable housing interest rates are currently around their lowest level for several decades, though it is notable that despite the historically low interest rates, affordability is still only slightly above its long-run average (Graph 70).

The household sector generally has significant buffers against adverse movements in housing prices and interest rates. Based on the most recent HILDA survey data available, in 2007 only 1 per cent of households with owner-occupier loans both had a loan-to-valuation ratio (LVR) of 90 per cent or more and spent more than 50 per cent of their disposable incomes on mortgage repayments (Graph 71). Although this share of more vulnerable households has edged higher in recent years, it was still the case that more than 90 per cent of owner-occupier households with mortgages had an LVR below 75 per cent and/or a debt-servicing ratio (DSR) below 30 per cent of income. The share of households with negative equity is estimated to be very low, with available data suggesting it is currently no more than 1 per cent of all households with owner-occupier mortgages.

Graph 71

Household Mortgage Vulnerabilities*

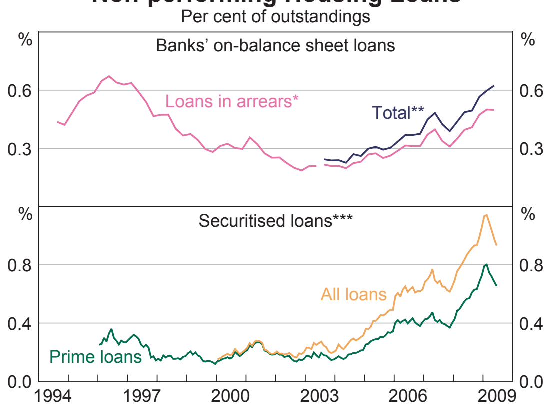


* DSR = Debt-servicing ratio; LVR = Loan-to-valuation ratio, using households' own estimate of current house price

Source: HILDA Release 7.0

Graph 72

Non-performing Housing Loans



* Loans that are 90+ days past due but otherwise well secured by collateral

** Includes 'impaired' loans that are in arrears and not well secured by collateral

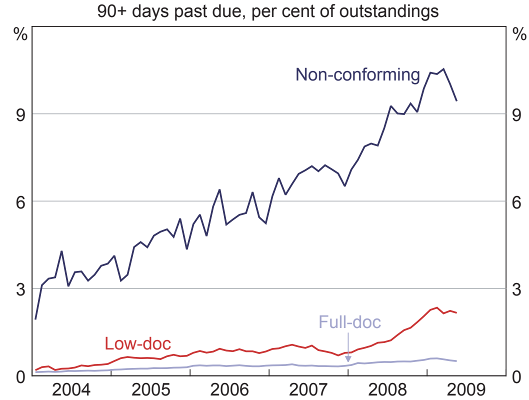
*** Loans securitised by all lenders, 90+ days past due

Sources: APRA; Perpetual; RBA; Standard & Poor's

The underlying condition of household balance sheets in Australia has helped limit the incidence of severe household financial difficulties during the current economic downturn. By loan value, the share of non-performing housing loans on banks' balance sheets was around 0.6 per cent in June, and around 0.9 per cent for securitised loans (Graph 72). Although these rates are higher than the low points seen in the earlier part of this decade, they are still low relative to international experience, despite some difficulties in making cross-country comparisons (as discussed in Box B).

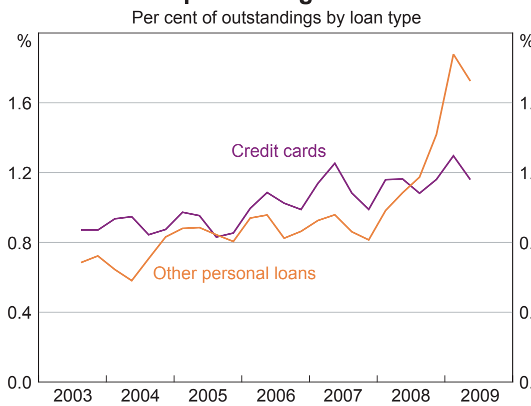
While measurement differences also complicate comparisons between on-balance sheet and securitised loans, the higher arrears rate for the latter group is mainly due to a greater share of low-documentation and non-conforming loans. The arrears rate on securitised low-documentation loans (for which a more relaxed standard of proof of borrowers' debt-servicing ability applies) was 2.2 per cent in May, having been fairly stable since the end of 2008, but one percentage point

Graph 73
Housing Loan Arrears by Loan Type*



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

Graph 74
Banks' Non-performing Personal Loans*



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

higher than a year ago (Graph 73). For non-conforming loans, which were made from outside the banking sector, the arrears rate was significantly higher: 9.4 per cent in May, up from 7.9 per cent a year earlier. In aggregate, it is estimated that currently around 25 000 households are 90 or more days in arrears on their housing loans, compared with a (revised) estimate of around 23 000 at the end of 2008.

Changes in the housing finance market over the past 10–20 years, such as the increased availability of low-documentation and non-conforming loans, and a wider range of lenders, have meant that a greater amount of credit has been more readily available to households. As well, there has been an increase in the share of households borrowing for a longer duration, or for investment and other purposes, compared with earlier periods. The increase in the share of households in arrears over the last few years partly reflects these higher debt levels. Arrears rates are also likely to have been affected by movements in interest rates. The arrears rate on (securitised) variable-rate loans increased 35 basis points over the 12 months to December 2008, and has since declined by 20 basis points; this compares to an increase of 10 basis points for fixed-rate loan arrears over the same period, with no subsequent decline. More recently the slowing labour market has contributed to higher arrears rates, with liaison with lenders suggesting that reductions in overtime and working hours have caused difficulties for some borrowers.

Across other types of household borrowings, arrears rates on credit cards have been little changed in net terms over the past couple of years (Graph 74). In contrast, there has been a sharp increase in arrears on other personal loans, partly due to non-performing margin loans. This in turn has resulted from the financial pressure arising from the steep decline in share prices over the past 18 months, and the consequent sharp decrease in loan collateral values and increase in margin calls.

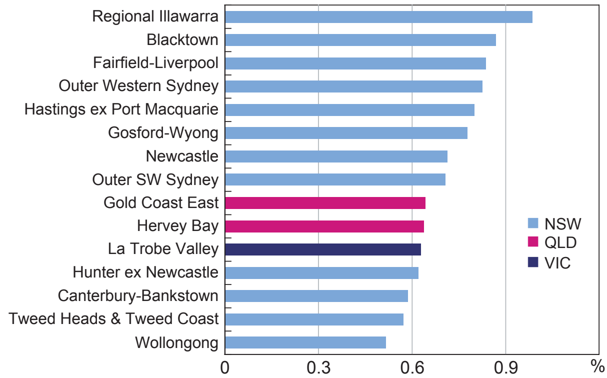
Housing loan arrears remain more prevalent in New South Wales than in the rest of the country, though recently there appears to have been some improvement in this state. In comparison, arrears rates in Western Australia have increased further while in Queensland they have been little changed, whereas the other states have seen some improvement. In general, non-metropolitan regions have seen a slightly greater deterioration than capital cities; within metropolitan regions, areas in western Sydney remain among the worst performing (Graph 75).

Developments in state-wide arrears rates have been reflected in recent increases in the rate of property possession applications in Western Australia and Queensland, as well as in increases in bankruptcies and other personal administrations (Graph 76). In contrast, these indicators have either stabilised or improved for households in other states. Overall, though, the number of households whose financial difficulties have deteriorated to the extremes of bankruptcy or lender property possession is very low in absolute terms.

Graph 75

Housing Loan Arrears by Region*

90+ days past due, per cent of outstandings, July 2009**



* With at least 2 500 loans outstanding.

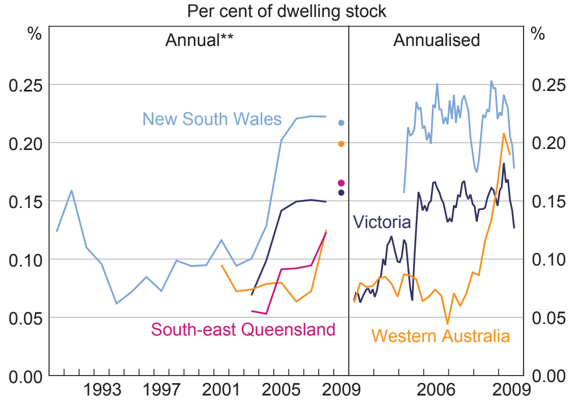
** Prime loans securitised by all lenders. Includes 'self-securitisations'.

Sources: ABS; Perpetual; RBA

Graph 76

Applications for Property Possession*

Per cent of dwelling stock



* Includes applications for possession of some commercial, as well as residential, properties

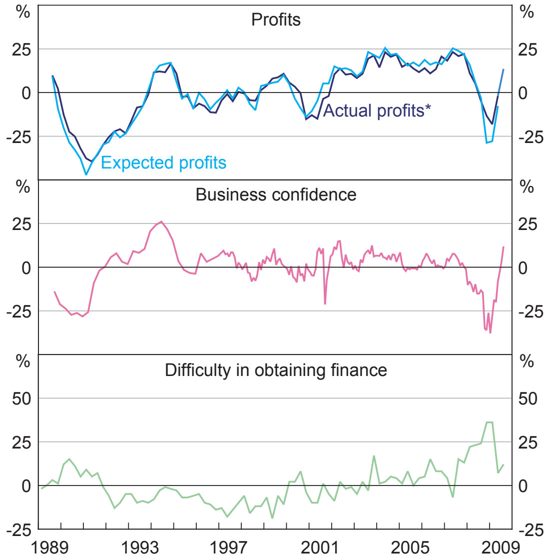
** 2009 estimates are annualised data up to August for NSW and VIC and June for QLD and WA

Sources: ABS; state Supreme Courts

Business Sector

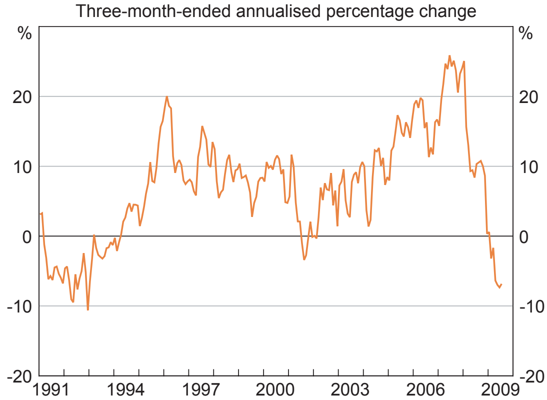
After many years of strong profit growth, the slowing economy and challenging financial conditions of the past 12 months have resulted in a substantial fall in business profits. Over the year to the June quarter 2009, aggregate business sector profits – measured by the national accounts – declined 6½ per cent, the largest annual fall since the 12 per cent decline to June 1991. Mining profits fell particularly sharply, reflecting a downturn in commodity prices. More recently, signs of an improving outlook for the business sector have emerged: share market analysts' earnings forecasts have been revised upwards, and firms' perceptions about current conditions and confidence for the upcoming period have recovered from their troughs – their lowest levels since 1991 – to be a little above their long-run averages (Graph 77).

Graph 77
Business Conditions Surveys
Net balance, deviation from long-run average



* Latest observation is for August 2009
Sources: ACCI and Westpac; NAB

Graph 78
Business Credit*
Three-month-ended annualised percentage change



* Includes securitised loans
Source: RBA

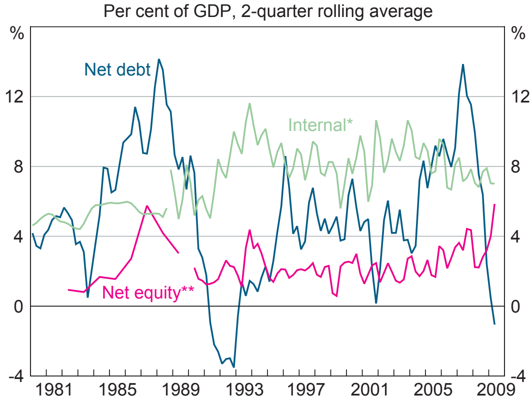
Surveys of firms' experience in obtaining finance indicate that this had become a more difficult task in the second half of 2008, before easing in the first half of 2009 (Graph 77). Finance availability remains a concern, though in recent months the share of firms reporting increased difficulties in sourcing finance has stabilised, and more firms are reporting an easing. Part of the reported tightening in credit availability is likely to have reflected lenders taking a more stringent approach to collateral requirements and loan conditions. Interest spreads have also increased since June 2008 – by 100–200 basis points for new large business variable-rate loans, and around 135 basis points for new small business variable-rate loans. Reflecting the easing in monetary policy, though, there has been a large decline in the average actual interest rate being paid on all outstanding debt (both fixed and variable) – around 345 basis points for large businesses and 230 basis points for small businesses since June 2008 – and this is likely to have influenced perceptions of finance availability reported in the surveys.

Conditions in wholesale credit markets have also eased recently, after a period where they were effectively closed to Australian borrowers. Large non-financial companies have issued around $23 billion of corporate bonds since the start of 2009, compared with only around $2 billion in the second half of 2008. While most of this issuance has been in offshore markets, investor appetite in the domestic market has increased in recent months.

Although firms, in aggregate, appear able to refinance as needed (albeit on tighter terms), the uncertain economic outlook has reduced their demand for credit. Firms have been looking to pay back loans and have been reluctant to increase gearing, even though debt finance is now cheaper. The net result of lower demand and tighter lending conditions is that business credit has been contracting, with the three-month annualised growth rate recently reaching its lowest point since the early 1990s (Graph 78).

Reflecting these developments, the share of overall business funding coming from debt finance over the past two years has fallen almost as much as in the early 1990s episode. In the first half of 2009 there was a net repayment of debt equivalent to around 1 per cent of GDP, compared with net new debt finance equivalent to nearly 14 per cent of GDP in the first half of 2007, when debt had been providing over half of total new business funding (Graph 79).

Graph 79
Business Funding



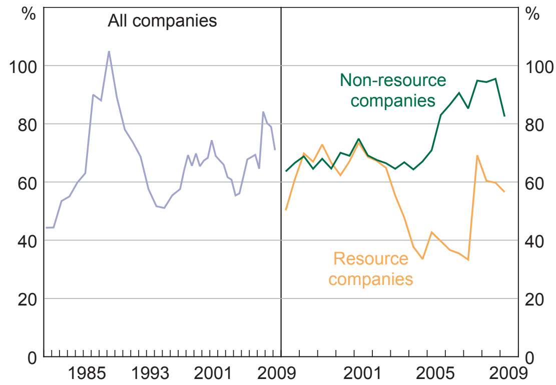
* Excludes unincorporates, includes public non-financial corporations
** Annual average prior to June 1990
Sources: ABS; ASX; Austraclear Limited; RBA

A distinguishing feature of the current episode, however, has been the success of listed companies in sourcing new funds through the equity market: the amount raised in the first half of 2009 was equivalent to around 6 per cent of GDP, more than double the average rate of the preceding 15 years. In comparison, in the early 1990s the reduction in debt finance was not offset to the same extent by a pick-up in equity raisings, and businesses, in aggregate, had considerably less capacity to fund their activities.

In total, listed non-financial and real estate companies have raised a record $63 billion of new equity since the start of 2009 – see Box C for further discussion. Reflecting the business sector's caution and a desire to reduce leverage, a large amount of these funds has been used to repay debt. Liaison with lenders and businesses has also indicated that banks have required some customers to raise additional equity, as a prerequisite for the continued availability of loan finance. Some of these raisings have also been by businesses looking to repair balance sheets following asset write-downs. While there have also been some raisings to fund ongoing business expansion, raisings for newly listed non-financial and real estate companies have been very weak. In the eight months to August there was only around $71 million of funds raised through initial public offerings, compared with an annual average of $5.4 billion since the start of the decade. An increase in offerings is likely over coming months, though, given the improving share market conditions since mid 2009. This improvement has also influenced other corporate financing decisions: a number of previously announced merger and acquisition deals have been cancelled, since the firms involved have now been able to raise equity on more attractive terms, instead of selling themselves or some of their assets.

The large amount of equity raisings undertaken this year has led to a fall in overall business-sector gearing. The aggregate gearing ratio for listed non-resource companies fell from around 95 per cent in December 2008 to around 82 per cent in June, while resource companies' gearing has declined slightly from around 60 per cent to 57 per cent, with further falls likely given recent large raisings (Graph 80). Equity raisings by more highly geared firms have narrowed the distribution of gearing ratios among large listed companies (Graph 81). Around two thirds of less geared firms have not raised equity, while the rest have only raised fairly small amounts.

Graph 80
Listed Non-financial Companies' Gearing Ratios*

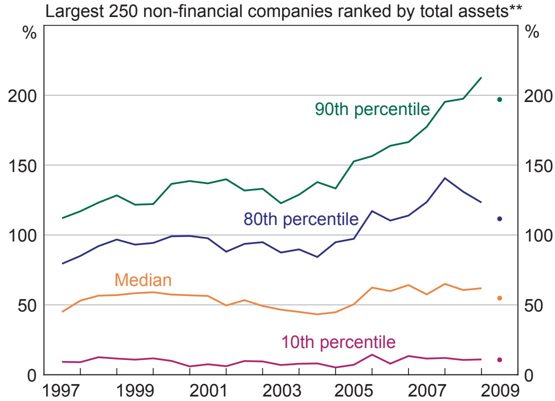


* Gross debt/shareholders' equity; book value; excludes foreign companies and listed property trusts

Sources: Morningstar; RBA

Graph 81
Distribution of Company Gearing Ratios*

Largest 250 non-financial companies ranked by total assets**



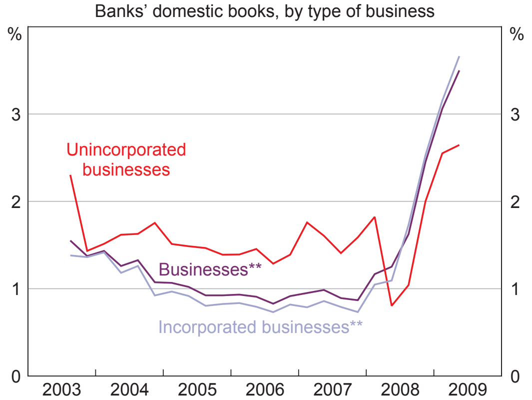
* Gross debt/shareholders' equity; book value; excludes foreign companies and listed property trusts

** Latest observation includes only companies that had reported to June 2009

Sources: Morningstar; RBA

Graph 82
Non-performing Business Assets*

Banks' domestic books, by type of business



* Includes 'impaired' loans and 90+ days past-due items that are well secured

** Includes bill acceptances and debt securities

Source: APRA

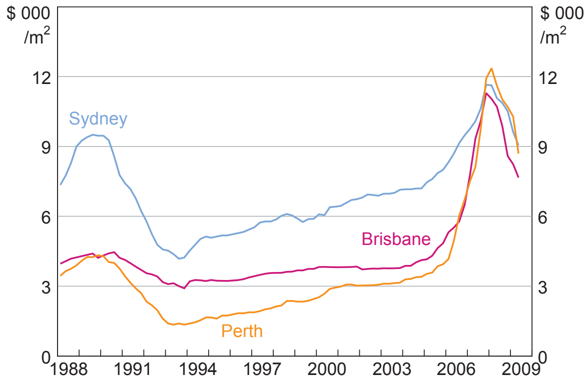
Firms have also been strengthening their financial position by increasing cash holdings, with business deposits at banks having increased 17 per cent in the year to July 2009, compared to an annual average growth rate of 13 per cent in the preceding five years. The increase in cash holdings is likely to reflect both precautionary holdings, given concerns about the availability of finance, and a transitory unwillingness to commit to new investment expenditure. The declines in both debt and business interest rates have seen a substantial fall in interest payments as a share of profits.

Although there has been some de-risking of firms' balance sheets of late – through the decline in gearing and an improvement in liquidity and interest coverage positions – the difficult economic and financial conditions of the past year have seen business loan delinquency rates increase. Non-performing business loans comprised 3½ per cent of banks' total business loans in June 2009, up from around 1 per cent in June 2008 (Graph 82). The deterioration over the past year has been evident for both small unincorporated enterprises and larger corporates. Similarly, the rate of failure of incorporated businesses has increased over the past year; it has steadied in recent months, but at an historically high level. This is in contrast to the failure rate among unincorporated businesses, which has remained broadly unchanged at levels below those experienced during the 1990s.

Commercial Property

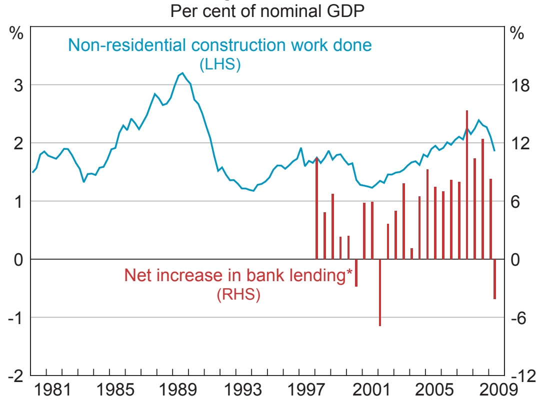
Conditions in the commercial property market have continued to weaken, with both declining white-collar employment and additional supply of office space contributing to increasing vacancy rates in the office property market. In line with this, national office capital values and rents have to date fallen by around 20 per cent from their recent peaks (Graph 83). This remains well below the 50 per cent peak-to-trough decline in capital values recorded in the early 1990s, partly due to a more moderate nationwide increase in new supply in the current episode (Graph 84). Brisbane and Perth, however, did see a strong supply response to the very tight vacancy rates and rapidly increasing rents experienced in the years running up to 2007. The build-up in supply has weighed on valuations, and both cities have recorded capital value declines of around 30 per cent.

Graph 83
Office Property Capital Values



Sources: Jones Lang LaSalle; RBA

Graph 84
Commercial Property Construction and Lending
Per cent of nominal GDP



* Six-month-ended annualised percentage change in outstanding loans for Australian commercial property; data post 2001 are for a matched sample of 27 banks

Sources: ABS; APRA; RBA

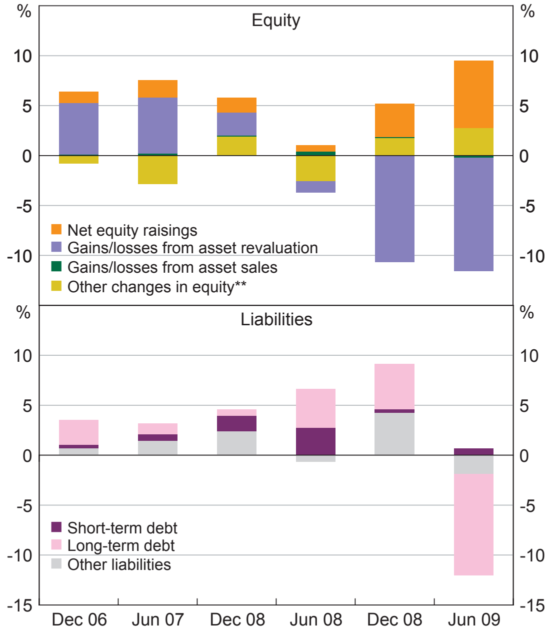
Uncertainty about valuations and future demand, for both office and multi-unit residential property, has contributed to the difficulties experienced by some developers in obtaining finance for new projects. As discussed in the chapter on *The Australian Financial System*, there has been a tightening in overall lending standards for commercial property (including construction of multi-unit residential property). Reflecting this, and also a fall in borrowing demand, aggregate commercial property lending contracted by 3 per cent over the six months to June 2009. Foreign-owned banks reduced their lending by more than the industry average, with liaison suggesting most of them are maintaining their existing client base, but are not looking to originate new deals.

Although bank lending has tightened over the past year, larger real estate businesses have generally been able to retain access to debt finance, with listed real estate investment trusts (REITs) having successfully refinanced $24 billion of debt since January 2009. Recent bond issues suggest that large real estate companies still have good access to domestic and offshore non-intermediated debt markets. Commercial mortgage-backed securities markets, which traditionally provided

Graph 85

REIT Balance Sheet Adjustments

ASX 200 REITs; percentage change over half year*



* Constituents as at half year end; change relative to total assets at start of each period

** Includes retained earnings

Sources: ASX; Morningstar; RBA; company reports

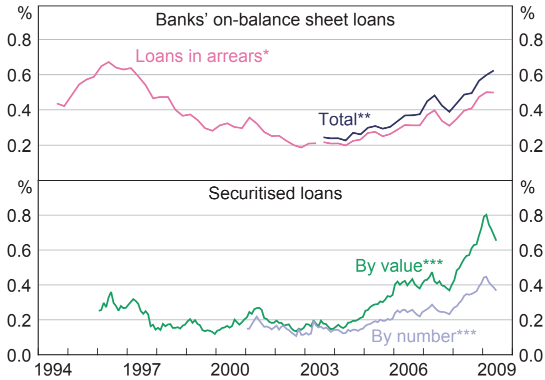
some diversification in funding for real estate companies, have remained all but closed, though real estate firms have generally been able to replace this financing, mainly through bank loans.

As with non-financial businesses, some real estate firms' access to bank finance has been partly contingent on their being able to raise additional equity capital. Reflecting this, listed REITs raised around $10 billion of new equity in the first half of the year, equivalent to around 7 per cent of their assets as at the start of the period, with additional amounts raised in the months since then (Graph 85). Recent equity raisings have also been used to repair balance sheets after downward asset revaluations, which have been equivalent to 11 per cent of total assets in each of the half years to December 2008 and to June 2009 – a notable contrast to a few years earlier when upward revaluations were a significant component of balance sheet expansion. An increase in retained earnings in the most recent period has also added to funding, but the combination of this and equity raisings has not offset the effect of asset revaluations and debt maturities.

Box B: Measurement of Housing Arrears

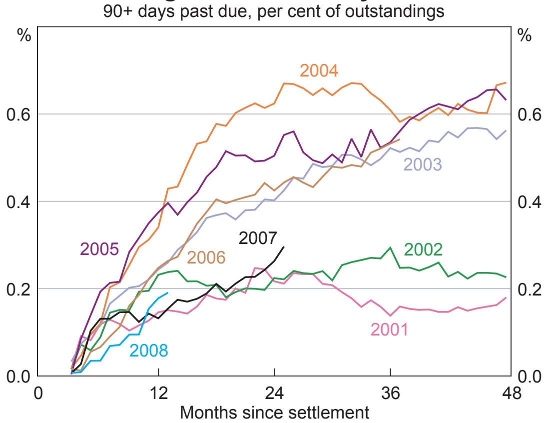
Whenever a borrower misses a payment on a loan, or does not make their required payment in full, they fall into arrears. Given the importance of housing mortgage debt to both household and financial institution balance sheets, the share of housing loans that are in arrears is a crucial indicator of household financial distress and of potential future losses to lenders. The origin of the financial crisis in US mortgage markets has increased the focus on arrears rate data. There are, however, numerous measurement issues that can complicate both cross-country analysis and assessments of national trends. These issues have probably artificially boosted reported arrears rates in Australia somewhat of late, especially those based on securitisation data.

Graph B1
Non-performing Housing Loans
Per cent of outstandings



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

Graph B2
Housing Loan Arrears by Cohort*
90+ days past due, per cent of outstandings



* Prime loans securitised by all lenders. For each annual cohort, individual months' arrears rates are weighted by the value of loans outstanding at each age. Includes 'self-securitisations'.
Sources: Perpetual; RBA

Aggregate housing loan arrears rates can be measured either as a share of the number of housing loans, or as a share of their total value (Graph B1, bottom panel). When assessing household distress, the arrears rate by number is the better measure; when considering the implications for lenders' balance sheets, the rate by value is more relevant. Arrears rates are typically greater by value than by number, because loans in arrears tend to be larger than average. Borrowers tend to fall into arrears in the first few years of the loan, before much principal has been paid down (Graph B2). The effect of this on measured arrears rates is amplified because average new loan sizes tend to increase over time, relative to the average size of loans already outstanding, as nominal housing prices and incomes rise.

The criteria for defining a given loan as being in arrears can differ across countries and lenders. In Australia, housing loans are defined as non-performing if they are either 'past due' – where repayments are at least 90 days past due, but the loan is well covered by collateral – or 'impaired' – at least 90 days past due or not in arrears but otherwise doubtful, and the loan is not well covered by collateral. Data from authorised deposit-taking institutions (ADIs) record both past-due and impaired loans on their balance sheets; in contrast, data on securitised loans only cover loans in arrears, whether the collateral is sufficient or not (Graph B1).

Lenders take varying approaches when designating a loan as being past due. In the 'scheduled balance' approach, the lender takes prepayments into account when calculating the total amount of payments that are behind schedule; this is the approach required by APRA for data collected from ADIs, and it is also used for securitised loans by some non-ADIs. In contrast, a 'missed payments' approach is used for other securitised loans, where a lender simply counts the number of missed payments, even if the borrower had previously made extra repayments. This is a stricter approach that probably biases these lenders' reported arrears rates up slightly, especially in Australia where many borrowers make prepayments ahead of their normal schedule.

The interpretation of arrears rates based on securitised loan data is also complicated by the lack of new securitisations over the past two years. The pool of these mortgages has dwindled from 26 per cent of all mortgages in mid 2007 to 13 per cent at present, and its composition is now less representative of the overall Australian mortgage market. As such, it is becoming a less reliable guide to trends in mortgage arrears. In addition, as has been noted in previous *Reviews*, there has probably also been some inflation of securitised loan arrears rates due to the declining flow of new loans into this pool: in Australia the practice has been that only loans with 'clean' payment records are eligible for securitisation. The upward effect of this on arrears rates is likely to diminish, however, as the pool of securitised loans ages, given that the peak time for arrears is in the first few years of a loan's life.

The disruption to securitisation markets and exits of some lenders from the market have probably had knock-on effects that might have boosted the arrears rates experienced by ADIs. Firstly, some existing ADI customers might be remaining on ADIs' books as non-performing loans, because they are no longer able to refinance with an alternative or non-conforming lender. Secondly, as ADIs increase their market share and absorb the business of exiting lenders, they are probably picking up some higher-risk customers that previously tended to borrow more from loan securitisers and other alternative lenders.

Sharp changes in interest rates can also distort reported arrears rates. The number of days in arrears is generally measured by dividing the accumulated arrears by the current monthly repayment. When variable mortgage interest rates fall, the required repayment also declines. If the move is large enough, a borrower that was two monthly payments in arrears before the rate decrease, could be defined as three months in arrears on the basis of the new, lower, required repayment amount. While this factor does not appear to have boosted arrears rates in

Australia – perhaps because the effect of the lower repayment burdens has more than offset it – in the United Kingdom it is thought that this made a large difference to reported arrears rates. In response, the UK Council of Mortgage Lenders has shifted its focus to arrears rates based on a threshold of the arrears being at least 2.5 per cent of the outstanding balance.

Even without measurement issues distorting the data, the implications of a given arrears rate will vary across countries and depend on other factors. If the legal system and lender practices encourage early foreclosure (as in the United States), this will depress arrears rates as foreclosed loans are repaid with the proceeds from the sale of collateral, but the share of households that have been affected, for a given level of arrears, will be greater than in other countries. Both households and lenders will be affected by the propensity of loans in arrears to progress to actual default and foreclosure. This will in turn depend on the willingness of lenders to modify loan terms, the availability of other sources of finance for refinancing, and the scope to sell the property given current market conditions.

An important factor determining the risk of loss to financial institutions is whether the collateral can cover the full loan amount.[1] For this reason, the greater the share of loans in arrears that are also impaired, the greater is the risk to the lender. In Australia, around one fifth of non-performing housing loans are considered impaired; in the United States the historical average is closer to two thirds. This difference implies that the riskiness of the US mortgage loan book would be greater than in Australia, even if arrears rates were equal and consistently measured.

1 *Other measures for reducing lender's risk such as mortgage insurance arrangements are also relevant.*

Box C: Equity Raisings and Company Gearing

Listed non-financial and real estate companies have raised a record $63 billion of equity over 2009 to date. Most of these raisings have been undertaken by highly geared companies to pay down debt and reduce leverage. Nonetheless, a large share of highly geared companies has not raised equity. In most cases, these companies either do not have large near-term debt maturities, or are repairing their balance sheets through other means such as asset sales and dividend cuts.

Companies that have raised equity

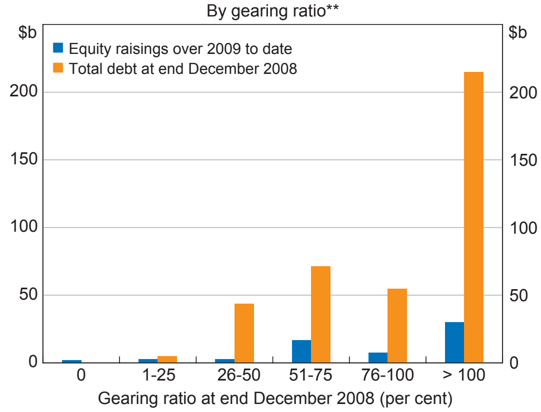
Most listed companies appear to have had good access to equity markets, though some have needed to offer a large discount to prevailing market prices. This has been expensive for the companies concerned, but together with the share market rally and increasing confidence about earnings, has induced strong investor interest.

Equity raisings have tended to be undertaken by more highly geared companies, with around 85 per cent of the $63 billion of equity raised having been issued by companies whose book value gearing (debt-to-equity) ratio was greater than 50 per cent at end 2008 (Graph C1). Companies with a gearing ratio greater than 100 per cent raised around $30 billion of equity (around half of the total amount issued), equivalent to around 15 per cent of this group's outstanding debt of $215 billion at end December 2008. As a result of these raisings, the aggregate gearing ratio of these companies has fallen by an estimated 60 percentage points to around 130 per cent.

Graph C1

Distribution of Listed Companies' Equity Raisings*

By gearing ratio**



* Non-financial and real estate companies
** Gross debt/shareholders' equity; book value
Sources: ASX; Morningstar; RBA

The tendency of more highly geared companies to raise equity is consistent across most industry sectors, but most obvious for resource companies (Table C1). The average gearing ratio at end December 2008 was around 120 per cent for resource companies that have raised equity this year, compared to around 25 per cent for those that have not. Only in the real estate sector was the gearing ratio of companies that raised equity lower than that of companies that have not; a few distressed real estate investment trusts with very high gearing ratios are yet to raise funds from the equity market.

Table C1: Equity Raisings by Listed Companies

Company Type	Equity raisings over 2009	Number of companies	Equity raisings as share of debt outstanding at end 2008	Gearing[a]	
				Dec 2008	Sep 2009[b]
	$b		Per cent	Per cent	Per cent
Resource	***32.5***	***786***	***30***	***60***	***45***
raised	32.5	367	42	120	55
did not raise	0	419	0	25	35
Non-resource	***17.0***	***760***	***9***	***95***	***75***
raised	17.0	230	22	100	65
did not raise	0	530	0	90	80
Real estate	***13.9***	***97***	***14***	***105***	***85***
raised	13.9	26	24	80	55
did not raise	0	71	0	185	215
Total	**63.4**	**1 643**	**16**	**85**	**65**
raised	63.4	623	30	100	60
did not raise	0	1 020	0	70	70

(a) Gross debt/shareholders' equity; book value
(b) Estimate based on company announcements
Sources: ASX; Morningstar; RBA

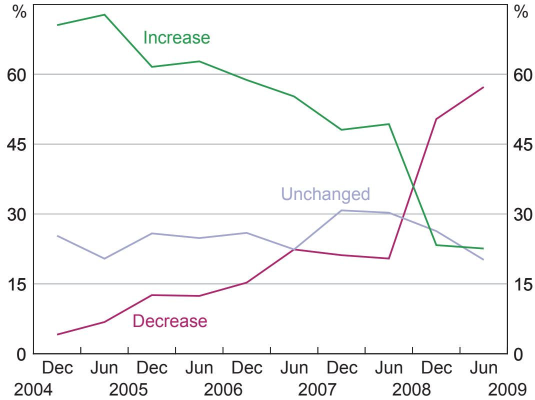
Companies that have not raised equity

The companies that have not raised equity this year can be broadly grouped into four categories:

- *Less-geared companies:* Around two thirds of less-geared companies – those with a gearing ratio below 50 per cent – have not raised equity, with continuing good profitability generally supporting these companies' moderate leverage. Those that have done so have only raised fairly small amounts, accounting for only about 15 per cent of the total value of equity issued.
- *Geared companies with less pressing near-term refinancing needs:* Despite the large amount of equity raised by companies with a gearing ratio greater than 50 per cent, over half of this group has not undertaken raisings. These companies have tended to be under less near-term debt refinancing pressure, with a number having very little, or no, debt maturing in 2009.
- *Geared companies that are comfortable with their leverage*: Some companies have been able to sustain business models involving a high gearing ratio due to more stable cash flows, in general, than other sectors. For example, around two thirds of infrastructure funds with a gearing ratio above 50 per cent have not raised equity. While some infrastructure funds have raised equity in response to concerns about asset valuations as well as their ongoing ability to service debt, others are perhaps reluctant to reduce leverage and return on equity.

- *Companies that are unable to raise equity or are reducing gearing in other ways*: While most companies have good access to the equity market, for some companies, investor concerns about their current circumstances or the sustainability of their business models have meant that they have been unable to source new funds through share issues. They have instead been selling assets or sourcing funds internally by cutting dividends. Indeed, this strategy has been adopted more broadly, with over half of ASX 200 non-financial and real estate companies reporting in June 2009 having announced dividend cuts, consistent both with lower profitability and a desire to build capital (Graph C2). Overall there has been a greater tendency for companies that are more highly geared to cut dividends. ✠

Graph C2
Changes in Dividends per Share
Per cent of ASX 200 companies reporting, semi-annual*



* Non-financial and real estate companies
Sources: RBA; company reports

Developments in the Financial System Architecture

As foreshadowed in the March 2009 *Review,* substantial work is underway in international fora to review financial regulations in light of lessons from the financial crisis. The major international bodies, such as the IMF, G-20, Financial Stability Board (FSB) and Bank for International Settlements (BIS) and its associated committees, have taken a prominent role in these discussions. As part of these efforts, the FSB (formerly the Financial Stability Forum) established additional internal structures to progress its work, and both the FSB and the BIS committees widened their membership substantially. As a result, Australia's representation on the FSB was expanded, the Reserve Bank and APRA became members of the Basel Committee on Banking Supervision (BCBS) and the Reserve Bank became a member of the BIS Committee on Payment and Settlement Systems.[2]

The FSB is playing a key role in co-ordinating these initiatives, with the reform proposals grouped around a number of main themes, including: strengthening capital regulations and liquidity requirements; improving the incentives for sound risk management through compensation practices; addressing systemic risk and interconnectedness and expanding oversight of the financial system more generally; and strengthening accounting standards. It is also considering issues around the exit from the extraordinary public sector financial support measures introduced over the past year or so. G-20 leaders are to consider these issues at their meeting on 24–25 September.

Australia's approach to these initiatives is being considered by members of the Council of Financial Regulators – APRA, ASIC, Australian Treasury and the Reserve Bank. The current focus is turning to how best to implement the reforms as they are developed, in order to accommodate different country experiences and capacities to implement changes. The need to distinguish country circumstances is particularly relevant for Australia, where regulatory arrangements have worked effectively over recent years and the financial system has weathered the past year or so better than many others.

The key items on the international financial regulatory agenda and some implications for Australia are outlined below, followed by details of other regulatory developments in the Australian financial system.

2 *For more detail on these organisations, their work during 2008/09 and the Reserve Bank's role in this work, see the chapter on International Financial Co-operation in the Reserve Bank of Australia's* Annual Report, 2009.

The International Regulatory Agenda and Australia

Strengthening the Capital Framework for Authorised Deposit-taking Institutions (ADIs)

There is general acceptance internationally that the capital framework needs to be strengthened and that the **quality of capital** in the global financial system needs to improve. This reflects the concern that, globally, the banking system entered the crisis with a Tier 1 capital standard that was insufficiently harmonised and less than fully transparent. The consensus among the major regulators internationally is moving towards defining Tier 1 regulatory equity to be predominantly ordinary shares and retained earnings, or their equivalent for non-listed institutions. This is based on the principle that the highest quality capital must be able to absorb losses on both a going concern basis and in the case of insolvency.

While the precise details of any changes are still to be determined by the BCBS, Australian banks should be well placed to accommodate these moves. As noted in *The Australian Financial System* chapter, following the capital raisings by the Australian banks this year, the Tier 1 capital ratio for the banking system is at its highest level in over a decade. In addition, APRA's existing prudential standard requires that the highest form of capital (such as ordinary shares and retained earnings) must account for at least 75 per cent of Tier 1 capital (net of deductions); other components, such as non-cumulative preference shares, are limited to a maximum of 25 per cent. In some other countries this split has been closer to 50:50.

Another area where further developmental work has progressed is the proposal to introduce **counter-cyclical capital requirements**. The aim is to promote the build-up of capital buffers during good times that can be drawn down during periods of stress, thereby limiting how much the banking sector amplifies the underlying cycle in economic activity. This objective was endorsed by the G-20 at their summit in April, after which the BCBS commenced work on how such an approach would operate in practice, including how to calculate the buffers and the method by which they would be increased and decreased. One of the key issues that needs to be worked through is the criteria for triggering the build-up and release of capital, with options including earnings or credit-based indicators. The BCBS is expected to outline its preferred approach to counter-cyclical capital requirements by the end of the year.

As noted in the March 2009 *Review*, an unweighted **leverage ratio** is to be introduced, as a supplement to the Basel II risk-based framework, aimed at putting a ceiling on the build-up of leverage in the banking sector. Further work is to be progressed by the BCBS over the coming months to determine how the ratio should be calculated. To ensure comparability, the details of the ratio will be harmonised internationally, including adjusting fully for differences in accounting standards. While the ratio should be as simple as possible, its design will also need to minimise any perverse incentives that could otherwise arise through its interaction with the risk-based framework.

As members of the BCBS, both APRA and the Reserve Bank will be participating in the development of these initiatives, with APRA having responsibility for determining any changes to Australia's prudential standards in response. At the international level, it is intended that the concrete proposals should be largely finalised by the end of 2009. While banks will be required to move in a timely manner to raise the quality and level of capital to the new standards, in doing so it is recognised that national supervisors will need to ensure that the stability of the domestic banking system and the broader economy is promoted. It is likely that any new capital rules will be subject to quantitative impact assessments during 2010, with material changes not implemented until 2011.

The above proposals are in addition to the significant changes agreed by the BCBS over the past six months to strengthen banking sector capital through the introduction of new rules that increase the **capital requirements for banks' trading books, resecuritisations and exposures to off-balance sheet vehicles**. Trading books were a major source of unexpected losses and the build-up in leverage during the financial crisis. In response, the BCBS has strengthened the rules governing market risk in the Basel II capital framework, by increasing the capital requirements to capture the credit risk of complex trading activities as well as introducing a more robust requirement for modelling risk, which should act to dampen the cyclicality of the minimum regulatory requirement. The BCBS is also introducing higher risk weights for resecuritisation exposures – such as collateralised debt obligations backed by asset-backed securities – to better reflect the risk inherent in these products. Capital requirements for short-term exposures to off-balance sheet asset-backed commercial paper conduits have also been increased significantly. Banks will also be required to conduct more rigorous credit analyses of externally rated securitisation exposures. Disclosure requirements for trading activities, securitisations and off-balance sheet exposures are also to be enhanced. The BCBS requires that the new rules be implemented by the end of 2010. To facilitate this, APRA is preparing a discussion paper setting out proposed changes to Australian prudential standards. Because Australian banks rely less heavily upon financial markets trading than most of their international peers do, the proposed improvements to trading book capital requirements are not expected to increase total Australian bank capital requirements materially.

Strengthening Liquidity Risk Frameworks

One of the lessons from the financial crisis is that some banks that had adequate levels of capital still experienced difficulties due to deficiencies in their **liquidity management**. In September last year, the BCBS released *Principles for Sound Liquidity Risk Management and Supervision*. These Principles provided further background for a broad-ranging review of liquidity standards that APRA already had underway, with a view to revising the prudential framework for liquidity risk management in Australia. A new draft liquidity prudential and reporting framework for Australia has recently been released by APRA for consultation. The draft proposals have regard to the experiences of Australian financial institutions during the crisis, as well as to the BCBS Principles and responses by other regulators internationally to those Principles. APRA is proposing that larger ADIs will need to move beyond the current requirement for five days of liquidity under stressed conditions, to 20 business days of self-sufficiency, and up to three months of resilience to generally adverse market conditions. APRA also proposes to require ADIs to provide more data to allow APRA and the Reserve Bank to better monitor liquidity risk.

APRA's proposed liquidity improvements are designed to be compliant with forthcoming updates to international standards. The BCBS is working to further increase banks' resilience to liquidity stresses by introducing a minimum global liquidity standard for application in a cross-border setting. This will include a liquidity coverage ratio relevant for a stressed funding scenario and a longer-term structural liquidity ratio.

Compensation and Incentives

Another key element in the effort to make the banking sector more resilient is strengthening the link between compensation practices and sound long-term risk management. With this in mind, the FSB released *Principles for Sound Compensation Practices* in April 2009, which were subsequently integrated into the supervisory review process of the Basel II framework, for immediate implementation. This process links individual bank capital requirements to compliance with the principles on compensation. APRA has released draft prudential standards and a prudential practice guide on sound compensation practices, which once implemented will strengthen the links between compensation and risk management in the prudentially regulated sector. Following a two-stage consultation process, APRA expects to finalise the standards in November 2009, with effect from 1 April 2010.

Systemic Risk, Interconnectedness and Oversight of the Financial System

In certain countries, the financial crisis was complicated by the size and interconnectedness of major cross-border banking institutions. There is a concern that these firms' contribution to risk in the financial system increases disproportionately with their size and that, in the event of any failure, they are likely to impose higher costs on the system than indicated purely by their size. The international response has been to examine whether such **'systemically important institutions'** should be subject to stronger regulation and oversight, reflecting these potential higher costs. This includes an assessment, to be undertaken by the BCBS, of the need for a capital surcharge to mitigate the risks associated with systemic banks. Other elements being investigated include: requiring such firms to develop specific contingency plans to allow for the winding up of the firm; establishing crisis management groups for the major cross-border firms to strengthen international co-operation during the resolution process; and examining the potential to strengthen the legal framework for crisis intervention and winding up of these firms. Since 2002, APRA has implemented a strategy of increasing supervisory intensity for larger firms in Australia presenting potential systemic risk. This supervisory strategy has proven reasonably successful to date.

Another initiative aimed at reducing systemic risk is the effort to improve the infrastructure underlying **over-the-counter (OTC) derivatives markets**. One focus of this work has been the move towards the establishment of central counterparties (CCPs) and exchanges for credit derivatives.[3] In recent months two new CCPs have commenced operations to clear credit derivatives transactions in Europe, and the flow of trades to the existing US-based CCP has increased markedly, albeit from a small base. In addition, to underpin improvements in regulators' ability to oversee OTC derivatives markets, several jurisdictions are considering introducing specific legislation that will require 'standardised' OTC derivatives to be cleared through a CCP, and all other transactions to be recorded in trade repositories.

3 *A discussion of the role of central clearing for OTC credit derivatives can be found in Box B of the March 2009* Financial Stability Review.

In Australia, APRA, ASIC and the Reserve Bank have been jointly monitoring international industry developments and assessing the conduct of business in the Australian OTC derivatives market. A first step has been to carry out a survey of OTC derivatives market participants in Australia, focusing particularly on risk management and post-trade processing practices.[4] The Survey results, released in May 2009, found that the scale of activity and magnitude of outstanding exposures in the Australian OTC derivatives market are low by international standards and, with the exception of interest rate and foreign exchange products, are also quite low in absolute terms. Nevertheless, the market plays an important role in the overall functioning of the Australian financial system and any disruption to activity could have wide-ranging implications. As such, the Survey identified several areas in which practices in the Australian OTC derivatives market might be enhanced to ensure that the market is well placed with regards to future growth and international best practice. The agencies have been meeting with industry participants, to discuss the Survey findings and to promote further enhancements.

A third area of work internationally in the area of systemic risk is on ensuring that all systemically important activity across the financial system is subjected to **appropriate oversight**, so as to prevent the emergence of new risks and regulatory arbitrage. This includes consideration of a consistent regulatory framework for the oversight of hedge funds, involving elements such as mandatory registration, ongoing oversight and provision of information to regulators so they can better ascertain systemic risk. In addition, the International Organization of Securities Commissions (IOSCO) is evaluating whether the regulatory changes that have been developed in, for example, the United States and Europe, to provide for stronger oversight of credit rating agencies, are consistent with its revised *Code of Conduct* for such agencies. IOSCO has also been examining ways to introduce greater transparency and oversight to certain financial products, particularly the securitisation and credit default swap (CDS) markets, as well as improving investor confidence in these markets. The focus in the securitisation market is on addressing the flaws and distorted incentives in the securitisation model, enhancing disclosure, strengthening investor suitability requirements and promoting adherence to good practices for investor due diligence. The focus in the CDS market is on addressing operational risk and the lack of transparency, as well as issues surrounding counterparty risk which are encapsulated in the work on CCPs.

Strengthening Accounting Standards

The financial crisis has resulted in a refocus on accounting standards, in particular those relating to recognition and measurement of financial instruments, off-balance sheet activities and loan loss provisioning. There has been progress in addressing some of these. However, the achievement of a single set of high-quality global accounting standards – an aim endorsed by G-20 leaders in April 2009 – remains complicated by the ongoing lack of convergence in approaches between the two key accounting standard setters, namely, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB). The IASB worked for some years in the first part of this decade to develop a single set of global accounting standards. Those standards, the International Financial Reporting Standards, have been implemented in many countries, including Australia, from the middle of the decade, whereas US firms have continued

4 *See APRA, ASIC, Reserve Bank of Australia (2009),* Survey of the OTC Derivatives Market in Australia, *May.*

to operate under the FASB standards. Achieving consistent standards, particularly on the measurement of financial instruments and provisioning, will therefore need further consultation by the independent standard setters.

Strategies for Exit from Financial Sector Support Packages

A further area that the international community is considering is **exit strategies from support programs**, such as the wholesale funding guarantee schemes that were introduced successfully in a number of countries, including Australia, in response to the extraordinary conditions experienced around 12 months ago. These temporary arrangements must ultimately be withdrawn, as it is in the long-run interest of institutions and the financial system for institutions to rely on their own credit standing for funding. The exit strategies for these arrangements will need to be carefully managed, taking into account market conditions and exit arrangements adopted by other countries (as discussed in *The Global Financial Environment* chapter). While these are decisions for governments, the Reserve Bank is participating in international discussions on this topic, including through the FSB. These issues are being actively considered by the Council of Financial Regulators, which continues to advise the Government on design aspects of the guarantee scheme.

Related to this is the future structure of **deposit protection arrangements**, which many countries expanded at the height of the financial turmoil last year. In a number of cases, these expanded arrangements are due to expire over the next one to two years. Some guidance for the appropriate design of future arrangements, and the transition process, can be drawn from international standards prepared by the BCBS and the International Association of Deposit Insurers. In Australia, the arrangements for deposits of $1 million and below are due to conclude in October 2011. To advise the Government on policy in this area, the Council of Financial Regulators is considering a number of issues, including transition arrangements from the current scheme, the appropriate cap and the merits of pre- and post-funded schemes. As there are significant linkages between the wholesale funding and deposit guarantee arrangements in Australia, the winding back and move to more permanent measures and any related effects are being considered jointly.

Other Domestic Developments

Market Supervision, Conduct and Disclosure

In August 2009, the Government announced that ASIC will take over, from the Australian Securities Exchange, responsibility for supervision of real-time trading on all of Australia's domestic licensed financial markets. Once implemented, the change will mean that ASIC will be responsible for both supervision and enforcement of the laws against misconduct on Australia's financial markets. There is a considerable amount of transitional work to be done in preparation for this transfer, including legislative changes, with the handover expected to be completed by the third quarter of 2010. This move will create a regulatory framework that would accommodate competition between market operators.

The ban on covered **short selling** of financial securities in Australia, which had been in place since September 2008, was lifted in May 2009. This followed a review by ASIC of market conditions, which concluded that the balance between market efficiency and potential systemic concern had moved in favour of the ban being lifted. In announcing the removal of the ban, ASIC noted that it would pay particular attention to short selling by participants (including activity by hedge funds and similar institutions) and it would not hesitate to reimpose the ban (using its enhanced powers under the *Corporations Amendment (Short Selling) Act 2008)* if it considered market conditions warranted such action.

Further to the disclosure issues that were detailed in the March 2009 *Review*, the permanent disclosure regime for short selling that is being developed by the Government is expected to be announced soon, and the arrangements for the disclosure of **securities lending** transactions are on track to move from the pilot phase to full implementation in December 2009. Consultation has also commenced on improving the **substantial holding disclosure** in respect of securities lending and prime broking, amid concerns that there has been a lack of transparency of substantial holdings acquired through such transactions. Similarly, concern over the adequacy of the disclosure regime for **equity derivatives** has resulted in the Government commencing a consultation process on ways to improve the existing regime.

National Regulation of Consumer Credit

As reported in previous *Reviews*, the Council of Australian Governments agreed in 2008 that all consumer credit regulation would be transferred to the Commonwealth Government. In June 2009, the Commonwealth Government introduced legislation to provide enhanced regulation of consumer credit provision and related consumer protections. Margin loans are now included as a financial product under the *Corporations Act*, making them, for the first time, subject to the same level of investor protection as other types of financial products regulated under the *Corporations Act*.

There will now be a national licensing regime regulating providers of credit or credit-related services, to be administered by ASIC, covering all 'credit providers' and 'credit assistants' – lenders, brokers and other intermediaries who assist consumers to obtain credit. People whose business will be regulated under the new regime will have to register with ASIC and apply for an Australian Credit Licence. Those who lose their licence will now be banned from operating Australia-wide, while licensee misconduct carries potential civil and criminal penalties.

The previous state-based Uniform Consumer Credit Code is to be largely replicated in the Commonwealth's credit regulation, with some additional features. For example, the provisions will now apply to residential investment property loans, lenders will be required to provide the consumer with information when a direct debit is dishonoured, and lenders will be prohibited from using essential household goods as security. The threshold below which consumers can apply for hardship provisions or stays of enforcement will also be raised significantly.

There will also be responsible lending requirements covering all credit licensees, not just credit providers. These requirements state that licensees must not provide or suggest unsuitable credit to a consumer. Licensees will have to assess that a credit contract meets the requirements of the consumer and that the consumer has the capacity to repay their obligations.