

Executive Roundtable and Professional Placements

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Session 2

Current Assessment:

Impact of Global Financial Turbulence on the Australian Financial System

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The Australian financial system continues to be in much better shape than many other financial systems around the world. It has, however, not been immune from developments abroad, with bank equity prices down, and funding costs and provisioning charges up considerably. In addition, the general increase in uncertainty has affected the banks' attitudes to lending.

- Australian banks continue to be highly profitable. Over the first half of 2008, the five largest banks recorded headline profits of around \$10 billion (post tax and minority interests), an increase of around 12 per cent compared to the first half of 2007.
- While some of the larger banks have announced significantly higher provisioning charges, analysts generally anticipate that headline post-tax profits in the second half of 2008 will only be around 10 per cent lower than in the second half of 2007.
- The recent increases in provisioning charges reflect a number of factors:
 - An increase in collective provisions due to a general deterioration in the credit environment in both Australia and New Zealand.
 - A substantial increase in individual provisions against exposures to highly leveraged companies that have been casualties of the credit turmoil (including Allco and Centro).
 - Sub-prime related provisions. NAB has announced a second-half provision of \$830 million on the liquidity support it provided to a conduit that invested in CDOs of ABS (to bring the total provision to \$1 billion). ANZ has announced a further mark-to-market loss of around \$160 million on a derivatives position with a US monoline insurer (\$386 million in total).
- Despite the NAB provisioning, the Australian banks have little exposure to the US sub-prime market and do not make non-conforming loans in Australia. More generally, asset quality remains strong by both international and historical standards.

As at June 2008, only 0.7 per cent of assets on banks' balance sheets were 'non-performing'.

- Non-performing housing and personal loan ratios have risen, but remain around, or only slightly above, their levels of a year ago. As at June 2008, non-performing housing loans accounted for 0.4 per cent of the value of Australian banks' outstanding on-balance sheet housing loans. (This compares with 2.7 per cent in the US).
- Australian banks' funding costs remain elevated, but the larger banks continue to be able to tap both domestic and overseas capital markets. Over the past six months the largest banks have increased their issuance of longer-term securities in the domestic market, and have also continued to issue offshore (albeit not in the same volume as in January and February this year). Total bond issuance on- and off-shore by the five largest banks was about \$7 billion in August compared to a monthly average of \$4 billion in 2007, and a peak of almost \$18 billion a month in early 2008. Overall, the average maturity of banks' outstanding bonds (both on- and offshore) has fallen only slightly since the onset of the credit market turmoil. Deposit growth has also been very strong recently as banks have been competing aggressively for deposits, particularly term deposits.
- Australian banks remain well capitalised, with an aggregate regulatory capital ratio of 10.6 per cent as at June 2008.
- Unlike some of their US and European counterparts, no Australian bank has had its credit rating downgraded since the onset of the turmoil. The four largest banks are rated AA by Standard & Poor's and Aa1 by Moody's (though NAB was recently placed on a negative outlook). Of the world's largest 100 banks, only a handful have higher ratings.
- The Reserve Bank's domestic market operations have been very flexible for a quite a few years, with the RBA willing and able to deal daily with a wide range of counterparties across a wide range of maturities. As a result, it was in a good position to respond to the turmoil in interbank markets that began around the middle of last year. The Bank's initial response was to significantly boost the pool of exchange settlement funds that commercial banks hold at the RBA; prior to the turmoil, this pool averaged less than \$800 million but on several occasions in the past year it has exceeded \$5 billion. In response to the turmoil, the Bank also lengthened the maturity of its repos and broadened the pool of securities it would accept under repo to include some commercial bank paper not previously accepted and certain RMBS and asset-backed commercial paper. Separate to these arrangements for day-to-day dealing, the RBA has worked with APRA and market participants to strengthen arrangements for dealing with extreme market disruptions. In such circumstances, the Bank would be prepared to accept RMBS to which the counterparty was 'related'. As a result of this policy, a number of banks have undertaken 'self-securitisations' of housing loans.