THE AUSTRALIAN BANKING SYSTEM - BUILDING ON STRENGTH

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I am pleased to have the opportunity today to address the "Business Banking 2005 Conference" and to offer an APRA perspective on some of the issues that currently face the Australian banking system.

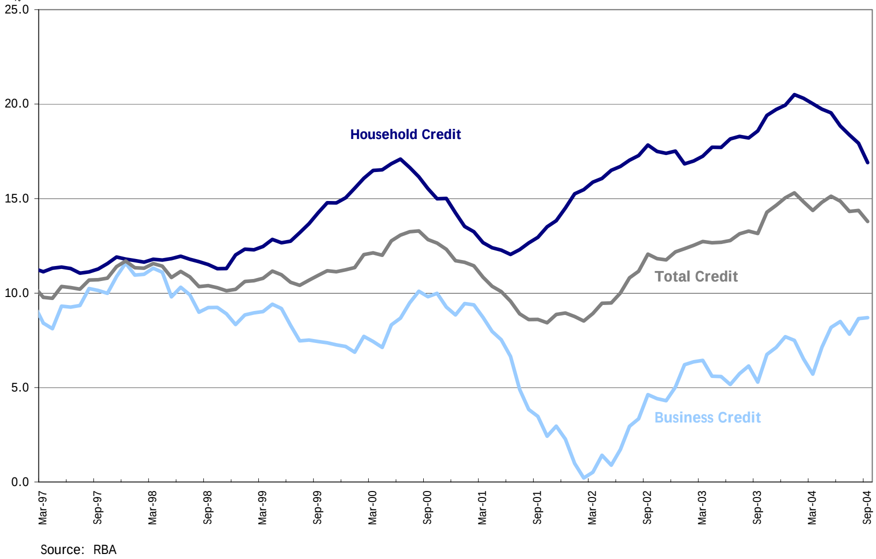
The story of the Australian banking system over recent years is one of rapid balance sheet growth but underlying strength. Over the past five years, the total assets of the banking system – and here I include building societies and credit unions – have almost doubled but prudential indicators confirm that the system has, throughout, remained in very sound condition. Profitability has been strong, impaired assets are at cyclical lows, the system is well capitalised and, broadly speaking, risks are being prudently managed. This positive diagnosis owes much to the favourable economic conditions that have prevailed in Australia for some time.

The recent performance of the Australian banking system, as we all know, has been dominated by developments in the housing market. The fast pace of lending for housing has been a major influence on revenue growth, on interest margins and funding sources, and on the diversification of income. It has also shaped the industry's risk profile. To provide a context for your discussions today, I would like to review the recent performance of the banking system and then focus on its challenges. Challenges posed by "good times" and by the changes now underway in the credit environment.

Recent performance

In Australia's low inflation, low interest rate setting of recent years, the household sector has been enthusiastic in its demand for housing finance – with a growing interest in investment property - and willing to accept much higher levels of indebtedness. Lenders have been very ready to oblige, in ever more innovative ways, and the consequence has been rapid growth in housing credit, reaching annualised rates of over 20 per cent. All sectors – banks, building societies and credit unions – have shared in this growth. Credit growth, in turn, fuelled substantial and widespread rises in residential property prices. This situation is changing. Over the course of this year, housing credit growth – though still strong - has slowed to rates in the mid-teens and property prices have lost their steam.

Graph 1: Credit growth
(Year-ended percentage change)

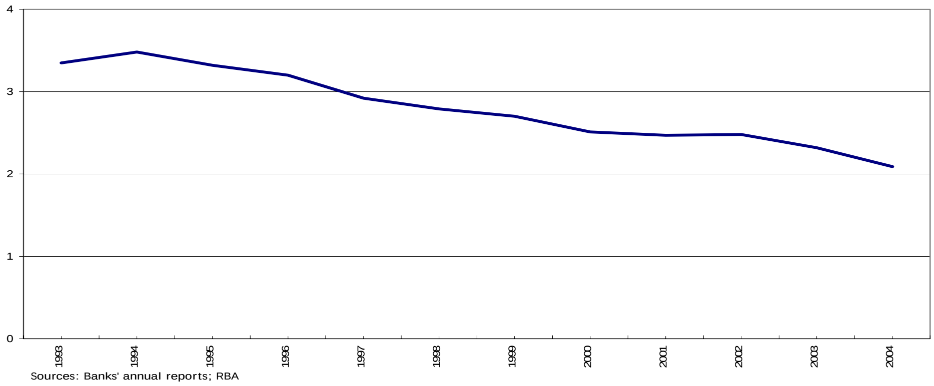


Source: RBA

Credit to the business sector, once the mainstay of the banking system, has been running at much lower, though rising, growth rates. Strong corporate profitability and the ability to tap equity markets and the growing corporate bond market to fund investment plans, have reduced the reliance of businesses on traditional intermediated finance.

The growth in its asset base has enabled the banking system to generate strong net interest income, notwithstanding continued downward pressure on interest margins. The average interest spread for banks is now only a little above 200 basis points, compared with about 270 basis points five years ago when the downward trend was already established. Developments in housing lending are inextricably linked with this compression of margins. Housing loans themselves are lower margin products than unsecured personal lending and business lending; the margins on home loans have been squeezed by vigorous competition in the home loan market; and the need to fund rapidly growing loan books has intensified competition in the retail deposit market and pushed banks increasingly into wholesale markets, particularly offshore. Banks themselves do not expect that the compression of interest margins has run its course.

Graph 2: Banks' average interest spread
(Five largest banks)



Two other factors have underpinned the profitability of the Australian banking system over recent years. One is the strong growth in non-interest income. Much of this has been from fees and commissions associated with the growth in lending volumes (both new lending and refinancing) but it has also been coming from funds management business and other services into which banks have diversified. The second, and more important, factor is further containment of costs. The trend here has not always been an even one; cost savings in some cases have been subsequently surrendered and information technology continues to devour budgets. Nonetheless, cost-to-income ratios for the four major banks have been brought down to an average of around 51 per cent, from around 55 per cent five years ago.

Behind these broad developments are some underlying structural changes in the Australian banking system. Four themes can be distinguished.

First, the banking industry continues to consolidate and become more concentrated. Over the past five years, for example, the five largest banks have taken their share of total housing lending undertaken by authorised deposit-taking institutions (ADIs) from around 75 per cent to almost 80 per cent. The total number of ADIs has fallen by 52 over the same period, primarily due to rationalisation within the building society and credit union sectors.

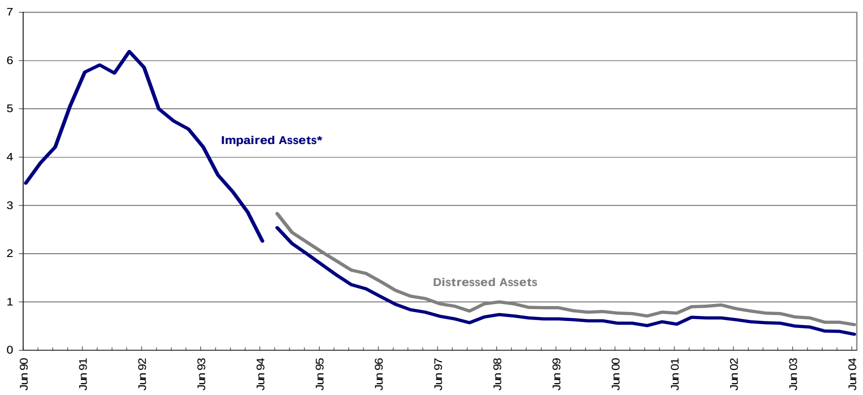
Secondly, for all the attention on housing market developments, the banking system has retained an external focus. Banks continue to have a significant volume of offshore exposures, in which New Zealand now looms larger than traditional markets such as the United Kingdom and the United States, and they have been selectively expanding into China and other parts of Asia.

Thirdly, the respective roles of banking institutions and capital markets in Australia continue to converge, as they are across the globe. One obvious example is the expansion in securitisation of residential mortgages. Securitised mortgages now account for one-fifth of outstanding housing finance, a share which has increased five-fold over the decade. In the main, regional banks, credit unions and building societies have been attracted to this market; securitised assets for building societies are around 36 per cent of their balance sheet assets. Another example of convergence is the increasing use of credit derivatives to transfer risks. Volumes of credit protection bought and sold have grown substantially over the past couple of years, albeit from a low base. This market is used largely by the major banks.

Finally, as the Wallis Committee foreshadowed, the boundaries between different types of financial institutions continue to blur. We have not seen the growth of many "allfinanz" institutions with significant banking and insurance arms but banks and other deposit-taking institutions have become increasingly involved in funds management. By June 2004, four Australian banking groups were counted amongst the top ten managers in Australia in terms of funds under management and they had half of the total funds managed by the top ten.

APRA monitors a range of indicators of the health of banks and other ADIs. A key indicator is asset quality, and here the picture is striking. At end June 2004, impaired assets accounted for only 0.33 per cent of banks' on-balance sheet assets – a figure that has been plumbing cyclical lows and is only one-twentieth of its record levels a decade earlier. In housing lending, the impaired assets ratio is lower again, with only 0.16 per cent of housing loans in arrears by 90 days or longer. On top of this, APRA is not seeing any worrying build-up of exposures in business lending or commercial property development, the banking industry's earlier Achilles heel, but banks have tightened their lending criteria for exposures to inner-city apartments. To date, most of the larger credit losses that banks have incurred appear to be related to specific circumstances surrounding the loans in question, rather than a systemic weakness in a sector or sub-sector.

Graph 3: Impaired assets
(All banks, per cent of on-balance sheet assets)

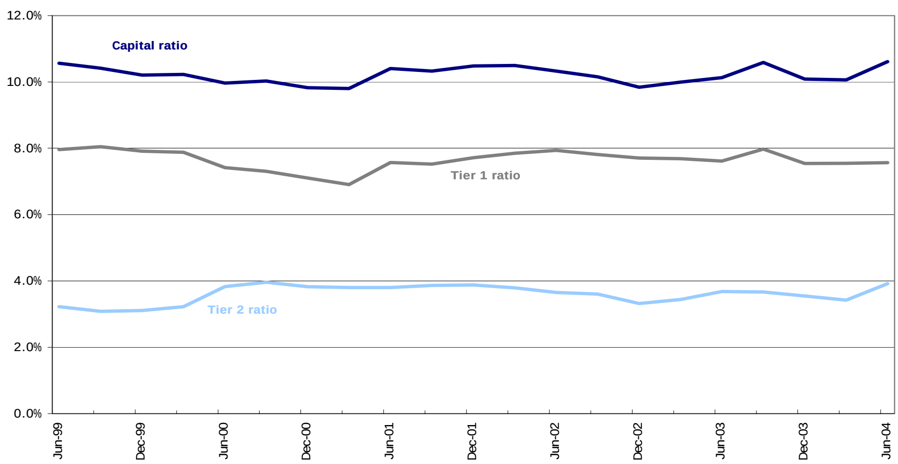


* Break in series due to change in reporting forms.
Source: APRA

Asset quality measures are, of course, backward-looking, but their current reassuring message has been reinforced by a forward-looking "stress test" which APRA undertook last year to help gauge the resilience of ADI housing loan portfolios in the event there were to be a substantial housing market correction. The stress scenario - a 30 per cent fall in housing prices and a significant increase in mortgage defaults - was well outside Australia's post-war experience but not as severe as the fate of some other industrial countries and regions over the past 20 years. The stress test demonstrated that the Australian banking system remains well capitalised and could withstand a substantial housing market correction without putting depositors at undue risk.

The underlying strength of the Australian banking system is also confirmed by trends in capital adequacy. Over the past five years, Australian banks have retained Tier 1 capital ratios at above seven per cent, making increasing use of innovative capital instruments, and total capital ratios at a little above 10 per cent. Building societies and credit unions have capital ratios that are higher than banks and, again, the recent trend is steady.

Graph 4: Risk-weighted capital ratios
(Banks - consolidated)



Other indicators and judgments round out our prudential assessments but none detract from the overall picture of a banking system in Australia in strong financial condition. As it should be, since it has been a major beneficiary of Australia's robust economic fundamentals for some time now.

The global context

This picture of growth and strength will be a familiar one to this audience. What may not be as familiar, however, is that a similar picture is being painted in most other major countries. Notwithstanding global shocks and geo-political uncertainties, banking systems have proven to be quite resilient even in countries that have not enjoyed Australia's good economic fortune. Internationally, banks have benefited from a long period of improving credit quality, with default rates at very low levels, and this has occurred despite a global trend of narrowing interest margins and increased competition from the non-bank sector. The low interest rate environment globally has held down funding costs, while strong housing market activity in many countries has boosted bank revenues. So, too, has strong consumer lending, such as credit cards and car loans, while rising fee income has compensated for declines in interest margins.

Beyond the supportive macroeconomic environment, a number of structural factors have also had an impact on the strength of banking systems globally. These include measures by banks to enhance efficiency through the rationalisation of operations, such as cost-cutting through reducing staffing levels, increased use of technology and recourse to outsourcing. They also include bank consolidation through mergers and acquisitions, although this wave has slowed down recently. Further, banks have been making increasing use of securitisation and risk transfer markets, such as credit derivatives, to spread their risks more broadly across the financial sector. Globally, banks continue to be well capitalised, with return on equity ratios that are the envy of most other sectors.

The Bank for International Settlements, which sits at the centre of international monetary matters, has nonetheless sounded a cautionary note in its most recent *Annual Report*. It has highlighted the potential risk that banks may have underpriced loans on the basis that the low interest rates and favourable macroeconomic environment that have existed for some time will continue into the future. The Bank has expressed concerned that the compression in interest margins has reduced the buffer that has traditionally been available to absorb an increase in defaults. It has also noted that banks are vulnerable to the rise in household indebtedness, which has occurred during a period of very low interest rates around the globe.

The challenge of "good times"

What the Bank for International Settlements is cautioning about, and what I would like to turn to now, is the need to maintain prudent banking practices in "good times". From the perspective of a prudential supervisor, economic prosperity has both positive and negative implications. On one side, strong economic activity generally allows financial institutions to prosper and build up their financial strength. On the other, continued prosperity can mask weaknesses in an institution's business model or an increased appetite for risk. APRA has been emphasising that Australia's continuing economic success should not dull the senses of institutions in risk management.

This message has added point given the changes now under way in the housing market and housing credit. As I have noted, growth in housing credit has been slowing, and it is expected to slow further over coming months. Even so, the Reserve Bank of Australia has warned recently that credit growth remains strong by international standards and a further slowing is likely to be required if it is to return to rates more consistent with the growth in household disposable income. Faced with a slowdown in housing lending and strong competitive pressures on margins, banks and other deposit-taking institutions will obviously be looking elsewhere to generate returns. The banks themselves have recently talked about the possibility of "irrational competition", and while this was originally a reference to the retail deposit market, it could apply with equal force to the provision of credit. In the current environment, there is no room for complacency in lending practices.

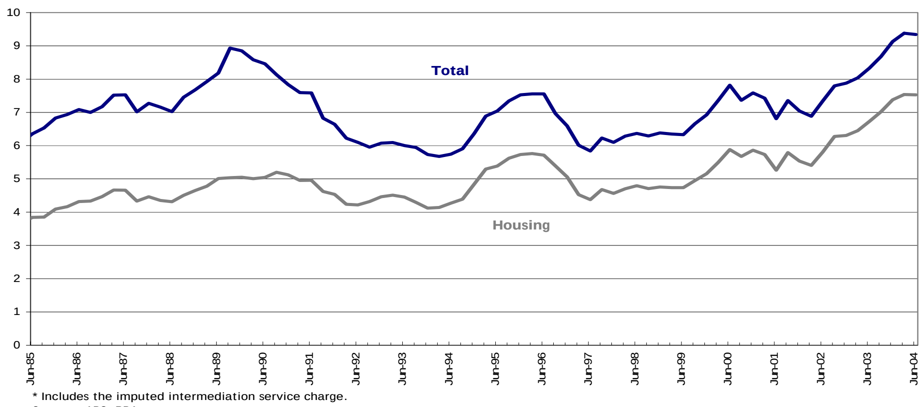
Complacency can take a number of forms, and we in APRA have been seeing some more than we would wish. One sign is the setting of ambitious business plans and growth targets for housing lending as if recent years' achievements can be readily repeated. Myopia, in other words. With growth in housing credit as a whole slowing, such targets can only be met by winning market share from competitors. Institutions will put themselves under undesirable pressure to dilute credit standards or to mis-price for risks if they seek to attain the unattainable.

Another sign is slippages in basic lending practices - in "bread and butter" banking. In housing lending, they cover such matters as:

- failure to independently verify customer data, particularly debt servicing ability, where loans are originated via mortgage brokers and other third-party channels;
- the use of various informal means of property valuation for loans on which lenders would traditionally require formal valuations;
- inadequate information systems which cannot capture electronically vital loan information for management and for reporting to APRA; and
- unsatisfactory error rates in compliance with the terms and conditions of lenders' mortgage insurance.

The need to maintain robust credit assessment processes in household lending is reinforced by the reality that debt servicing burdens of households are now at record levels and that banks are no longer relying on conservative rules of thumb when assessing a borrower's capacity to repay debt. The traditional "30 per cent rule", under which lenders would limit repayments to no more than 30 per cent of a borrower's gross income, has been giving way to a debt-servicing ratio approach, which treats all income above a cost of living estimate as potentially available for debt servicing. This approach allows higher income applicants to borrow more, since cost of living expenses are regarded as a relatively fixed commitment for individuals. Conservatism can be built into this approach through a loading on expected interest rate movements and cost of living estimates, and it may be used with new "scorecard" techniques to capture more relevant details about borrowing capacity. The fact remains, however, that the reliability of this type of approach has not been tested in adverse circumstances and households have, in the meantime, been able to gear-up more heavily.

Graph 5: Household interest payments



* Includes the imputed intermediation service charge.
Sources: ABS; RBA

A third sign of complacency is under-investment in risk management capabilities. APRA's strong message to regulated institutions is that they need to maintain their spending and management focus on risk management systems and staff to ensure that these keep pace with the growth of their operations and the risks they face when undertaking new activities. Cost-cutting in this area is not good long-term business sense. This point applies across the whole risk spectrum, not just to credit risk. In traded market risk, for example, APRA has found that some deposit-taking institutions have not been devoting sufficient risk resources to their treasury operations. We have seen cases where even basic risk management functions such as segregation of duties and monitoring of limits have been compromised by insufficient resourcing. This may reflect a misguided view by management that market risk is negligible because of the small value-at-risk limits in place compared to credit risk measures, but it overlooks the fact that operational risks in the treasury area can be very high. No one needs reminding of the scale of losses in one recent incident close to home.

Operational risk, likewise, requires a strong and well-resourced risk management function. Operational risks arise in outsourcing, business continuity management and, particularly, in the robustness and security of IT systems. These systems are pivotal to the provision of 24 x 7 banking operations and yet we hear, too often, of system failures after upgrades, hardware and software problems, computer viruses and denial of service attacks. We are also now witnessing a sharp increase in the number of internet-based fraudulent attempts to gain access to customer accounts.

The prudential framework

Just as supervised institutions need to keep their risk management systems up to the mark, APRA itself needs to ensure that its prudential framework is rigorous, risk-focussed and adaptable to changing market circumstances and business practices. The prudential framework for banking is a comprehensive and well-seasoned one. Nonetheless, we have seen need to strengthen our capital and risk management standards in response to developments that were causing us unease, particularly in housing credit. Our actions have involved:

- the removal of certain types of capitalised expenses – such as loan origination fees and mortgage broker commissions – from calculations of regulatory capital;

- a tightening of prudential standards for "low doc" and other non-traditional mortgage loans where ADIs do not independently verify the borrower's servicing capacity;

- an improved capital framework for lenders' mortgage insurance, which assumes a significant proportion of credit risk in housing lending in Australia; and

- a new prudential standard on business continuity management.

These last two initiatives are currently in the public consultation stage.

These actions will be augmented by two new prudential standards governing behaviour in our regulated institutions. These are still "work in progress". The first is a proposed fit and proper standard for responsible persons, which will put the onus on regulated institutions to ensure that directors, senior managers, auditors and (where relevant) actuaries of these institutions have the competence and integrity necessary to perform their roles. The second is a proposed standard for corporate governance, which aims to promote the highest standard of prudence by boards, the pivotal decision-making body in an institution. APRA will shortly be releasing a second round of discussion papers on these two standards.

Over the next few years, the regulatory landscape for banking in Australia will also change in fundamental ways through two international initiatives, running on international timetables. One is the adoption of International Financial Reporting Standards (IFRS), the other is the new global framework for capital adequacy, known as the Basel II Framework. These are large subjects in themselves and I will confine myself to some general comments.

APRA fully supports the adoption of IFRS in Australia, from 1 January 2005, and is working closely with regulated institutions on implementation programs. APRA itself will be seeking to align its prudential and reporting standards with the new Australian accounting standards as much as is practicable, since the latter provide a widely accepted basis for the recognition and measurement of assets, liabilities and capital.

There will, however, be points of departure. APRA's prudential framework is forward-looking and primarily risk-based, while accounting standards focus mainly on verification and reporting of past transactions and events. Additionally, APRA's prudential requirements are aimed at protecting the interests of beneficiaries (ie depositors and policyholders), particularly in adverse circumstances, while accounting standards focus on evaluating the interests of the economic owners of an institution on a going concern basis. Prudential and accounting standards already depart on such matters as the treatment of goodwill, which APRA does not recognise as an asset in calculations of regulatory capital. They are likely to depart on other items such as general provisions, which are an important element in the regulatory capital framework (including Basel II) but which IFRS now rejects in their traditional treatment because of concerns about earnings management. The prudential implications of IFRS will be the subject of a series of discussion papers that APRA will be releasing in coming months.

The Basel II Framework, which will be implemented in Australia from end 2007, offers very real benefits in improving the overall efficiency and resilience of the Australian banking system. These benefits may have been overlooked in the recent pre-occupation with implementation costs and the size of possible reductions in regulatory capital, and it is important to bring these benefits to the forefront.

The original Basel Capital Accord was an important step in achieving international convergence of regulatory capital requirements for banks and, in many countries, raising what were inadequate levels of bank capital. That said, the Accord's relatively simple "one-size-fits-all approach" created opportunities for regulatory arbitrage and potential distortions in the provision and pricing of banking services. The Accord was increasingly unable to deal with the liberalisation, innovation and sophistication of the market place. Also, it became clear that capital should not only be seen as a buffer to absorb losses but that capital rules should reinforce prudent behaviour.

In addressing the deficiencies in the original Accord, the Basel Committee was keen to leverage off what banks were doing to better measure and manage their risks. Ultimately, the Basel Committee concluded that the banks' own economic equity models were not sufficiently robust, nor comparable, to be used for calculating regulatory capital. The Committee has used the "half way house" of the Basel II Framework to achieve its goal of further strengthening the soundness and stability of the international banking system while guarding against the danger that the regulation of capital adequacy might become a significant source of competitive inequality.

The Basel II Framework is more reflective of the underlying risks facing banks and other deposit-taking institutions. Currently, for example, ADIs are not required to hold more regulatory capital against loans to companies rated "speculative" than to those of "investment grade". In contrast, under the standardised approaches of the Basel II Framework there are substantially more risk buckets. Under the advanced approaches, those larger Australian banks that have been at the "cutting edge" on particular aspects of risk management will be able to better align their regulatory capital to their actual risk of economic loss. Further, the Framework provides incentives for ADIs to improve their risk measurement and management systems and processes. This, in turn, should lead to improved tools for more accurate pricing of risk.

Conclusion

Let me bring my remarks to a conclusion. The Australian banking system has been enjoying a very strong run and we in APRA would obviously be happy for that to continue. Hence my title of "Building on Strength". Housing market developments have been the dominant influence on the current shape and risk profile of the system, but this is changing. Many commentators see business banking as the next competitive battleground. Hence, this Conference could not be more timely or appropriate. My cautions about the need for robust credit assessment procedures, appropriate pricing for risk and for well-resourced and vigilant risk management apply to all forms of lending. Where business banking takes lenders into new types of ventures, or involves bringing new products to the market, the importance of robust risk management policies and procedures becomes even more critical.

"Bad loans are made in good times". This is an old banker's aphorism but it has a timely ring. Heed the message, and enjoy the Conference!