

2. The Australian Financial System

The Australian banking system remains well placed to cope with shocks from abroad, such as those that may emanate from the ongoing problems in Europe. Australian banks' direct exposures to the most troubled euro area countries are small and declining. Disruptions to wholesale funding markets and/or a deterioration in global economic activity would likely be more important contagion channels to Australian banks from any escalation of the European problems. However, the banks are better positioned to manage these risks than prior to the 2008–2009 crisis, having substantially strengthened their capital, funding and liquidity positions over recent years. Markets seem to be recognising the Australian banks' relative financial strength: their share prices are over 10 per cent higher over the past six months, compared with a broader Australian market increase of 4 per cent over the same period (Graph 2.1).

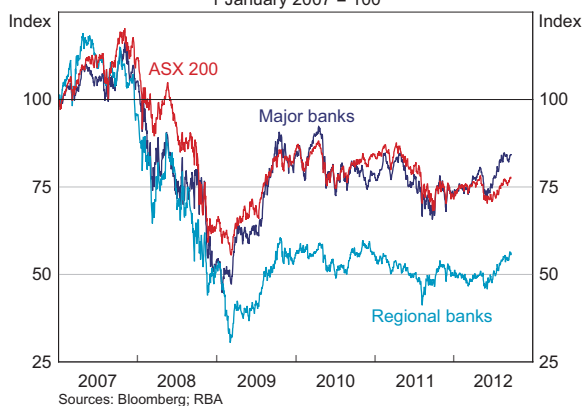
While banks' overall asset performance has improved in recent quarters, challenging conditions in a few

parts of the business sector are contributing to an elevated flow of new impaired assets relative to the pre-crisis period. If macroeconomic conditions were to deteriorate, banks' asset performance would therefore be starting from a weaker position than in past years. Although the housing market has been weak, the key risk to the banks' housing loan portfolio would be a rise in unemployment large enough to damage many borrowers' capacity to meet their repayments.

The growth in banks' profits has slowed in recent reporting periods as their bad and doubtful debt charges have stopped falling, or in some cases, increased. Revenue growth has been constrained by modest credit growth and pressures on margins. Even so, aggregate profitability of the banks remains strong. Looking ahead, how banks respond to these obstacles to profit growth could be a key factor for financial stability over the medium term. While there is little evidence over the past year that they have been imprudently easing lending standards in a bid to boost their credit growth, they are seeking ways to sustain the growth in their profitability, including, in some cases, through cost cutting. Such strategies will need to be pursued carefully to ensure that risk management capabilities and controls are maintained.

The general insurance industry remains well capitalised and underwriting results have returned to more normal levels after the adverse effects of the natural disasters in late 2010 and early 2011. Lenders' mortgage insurers (LMIs) have in some cases reported reduced earnings during the past six

Graph 2.1
Share Prices
1 January 2007 = 100



months, as recent weakness in residential property markets has boosted the number and average size of claims on them. Were this property market weakness to be extended and coupled with higher unemployment, LMIs could experience even higher claims. The LMI sector is well positioned, though, because its capital requirements are calibrated to withstand a substantially weaker outcome than is currently in evidence.

Banks' Euro Area Risks

Australian-owned banks continue to report very limited direct exposures to the sovereign debt of euro area countries facing the greatest fiscal problems (Table 2.1). On the assets side of their balance sheets, the banks are still indirectly exposed to euro area sovereign debt problems through several channels. One is through their claims on euro area banks – such as the French, German and Dutch banks – which in turn have substantial exposures to the weaker euro area countries. Australian-owned banks' exposures to these euro area banks are quite low, however, at less than 1 per cent of their consolidated assets as at end March 2012. A more important indirect transmission channel would be if the European problems resulted in a sharp slowing in global, and consequently, Australian economic growth. Depending on the nature and size of

any economic slowdown, Australian banks' asset performance could deteriorate in such a situation.

As the experience of the past few years has shown, the biggest risk from an escalation of European problems comes from the liabilities side of the Australian banks' balance sheets. In particular, tensions in Europe could trigger a renewed increase in risk aversion and disruption to global capital markets, which would likely undermine Australian banks' access to offshore wholesale funding. Compared with several years ago, however, banks are in a better position to cope with such disruptions.

Funding and Liquidity

The ongoing difficulties in Europe have been contributing to volatile funding conditions for Australian banks, but in recent quarters wholesale funding pressures have eased from the levels of late last year. Offshore investors have focused on the relatively strong position of the Australian banks compared with those in some other countries. The banks have therefore been able to take advantage of periods of more favourable market conditions to issue opportunistically.

The Australian banks issued around \$50 billion of bonds in the past six months, mostly in unsecured form. This was a little less than the amount issued in

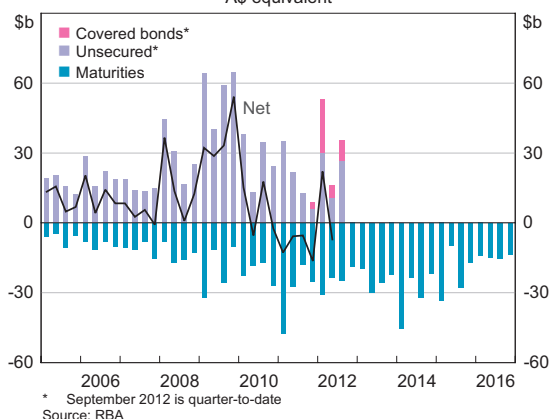
Table 2.1: Australian-owned Banks' Claims on the Euro Area
Ultimate risk basis, as at end March 2012

	Total		of which:		
	\$ billion	Per cent of assets	Banks Per cent of assets	Public sector Per cent of assets	Private sector Per cent of assets
Euro area	48.1	1.6	0.7	0.3	0.5
<i>of which:</i>					
Greece, Ireland, Italy, Portugal and Spain	4.7	0.2	0.0	0.0	0.1
France, Germany and the Netherlands	38.9	1.3	0.6	0.3	0.4

Source: APRA

the previous six months, and slightly exceeded their maturities over the same period (Graph 2.2). Around \$15 billion of these maturities were government-guaranteed bonds, the outstanding stock of which has declined to around \$85 billion in August 2012, down from a peak of \$150 billion in June 2010. Of the issuance of wholesale debt over the past six months, about \$14 billion was covered bonds, with about 85 per cent being issued offshore. On average, the major banks have now used around one-quarter of their covered bond issuance capacity as defined by a regulatory cap. Given covered bonds have tended to be more resilient to turbulent funding market conditions, the cap on their issuance may warrant keeping some issuance capacity in reserve in case conditions deteriorate again.

Graph 2.2
Banks' Bond Issuance and Maturities
A\$ equivalent



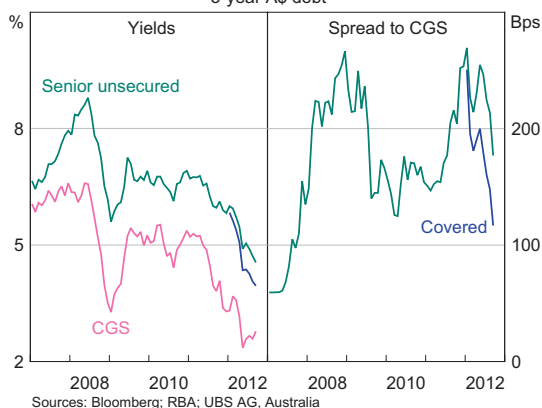
Conditions in residential mortgage-backed securities (RMBS) markets have also improved in the past six months, with \$8 billion of these securities issued over this period, compared with the very low issuance in the March quarter. Around 75 per cent of the recent issuance by value has been by smaller institutions. The Australian Office of Financial Management continued to support some of these deals, though it was not needed in some eligible deals recently due to relatively strong private sector demand, consistent with improving market conditions. RMBS spreads in

secondary markets are still generally wider than they were in 2011, though well below the 2009 peaks.

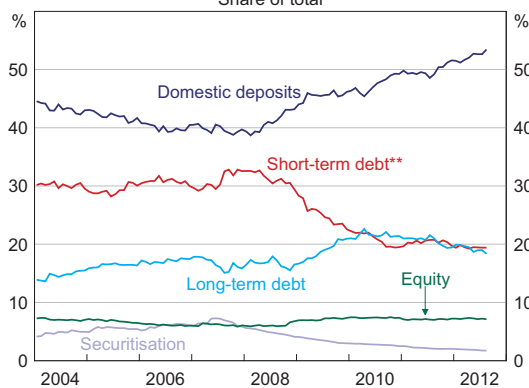
The pricing of banks' senior unsecured bonds relative to benchmark rates remains higher than in recent years but significantly less than the peaks at the end of 2011, when concerns about the euro area banking sector and sovereign debt crisis intensified. Spreads relative to Commonwealth Government Securities on 5-year unsecured bank bonds have declined by around 80 basis points in recent months and are now at similar levels to mid 2011 (Graph 2.3). Continued demand for high-quality assets and limited issuance has seen spreads on covered bonds narrow considerably since the start of the year.

The risks Australian banks could face from their use of wholesale funding are being mitigated through the ongoing compositional change to the liabilities side of their balance sheets (see 'Box A: Funding Composition of Banks in Australia'). Deposit growth has remained strong, at around 9 per cent in annualised terms over the past six months, reducing banks' wholesale funding needs. However, the strong competition for deposits has widened their spreads relative to benchmark rates, contributing to an increase in banks' funding costs relative to the cash rate. Deposits now account for 53 per cent of banks' funding, up from about 40 per cent in 2008 (Graph 2.4). The major banks are generally aiming

Graph 2.3
Major Banks' Bond Pricing
5-year A\$ debt

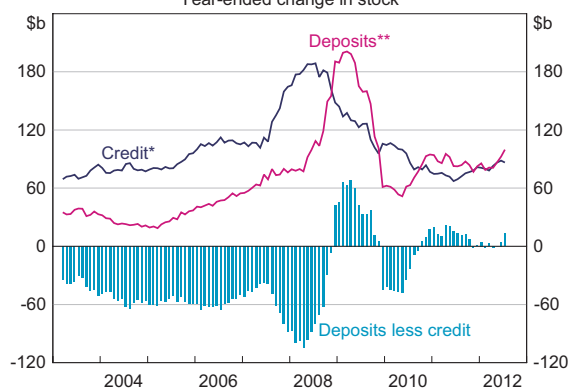


Graph 2.4
Banks' Funding*
Share of total



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

Graph 2.5
Major Banks' Credit and Deposits
Year-ended change in stock



* Excludes securitisations
** Excludes intragroup deposits
Sources: APRA; RBA

to fund new lending with new deposits on a dollar for dollar basis; changes in their stock of lending and deposits show this has been happening for some time (Graph 2.5). This approach is likely to support a continued upward trend in the proportion of funding sourced from deposits, at least in the near term. Stronger competition for deposits would mean banks would face the prospect of their margins coming under pressure from further increases in funding costs, though the risk to their profits would be mitigated to the extent banks can reprice their loan books.

Banks have also improved their ability to manage funding stress by strengthening their liquidity positions. Liquid assets – cash and securities eligible for normal repo operations with the RBA – currently account for about 10 per cent of banks' domestic Australian dollar assets, up from around 6 per cent in early 2007 (Table 2.2). In addition, banks' holdings of self-securitised RMBS have increased, and now total around \$180 billion (7 per cent of domestic Australian dollar assets), up from about \$145 billion in 2011. The composition of liquid asset portfolios has also changed over recent years, with an increasing share held in government securities

Table 2.2: Banks' Liquid Assets
Domestic books, excludes interbank deposits

	March 2007		March 2009		March 2012	
	Level \$ billion	Share ^(a) Per cent	Level \$ billion	Share ^(a) Per cent	Level \$ billion	Share ^(a) Per cent
Liquid assets	98	6	199	8	270	10
Commonwealth Government & semi-government securities	6	6	29	15	82	30
Short-term bank paper	54	56	94	47	59	22
Long-term bank paper	9	10	42	21	79	29
Other ^(b)	28	29	33	17	50	18
Total bank assets	1 640		2 411		2 636	
<i>Memo: Self-securitised assets</i>	<i>0</i>		<i>142</i>		<i>178</i>	

(a) Share of total A\$ assets, subcomponents are the share of liquid assets

(b) Includes notes and coins, A\$ debt issued by non-residents and securitised assets (excluding self-securitised assets)

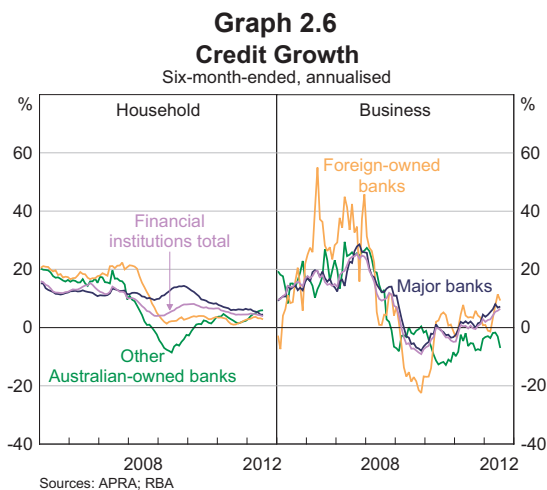
Sources: ABS; APRA; RBA

and long-term bank bonds, and less in short-term bank paper. These trends in banks' liquidity positions are partly a response to the forthcoming Basel III liquidity standards which will require banks to hold more and higher-quality liquid assets. A structural shortage of higher-quality liquid assets in Australia, stemming from the low level of government debt, means banks will also need to access the RBA's Committed Liquidity Facility to meet part of their Basel III requirements. The Australian Prudential Regulation Authority (APRA) is in the process of developing a framework for determining the extent to which banks will be able to count this facility towards meeting their Liquidity Coverage Ratio versus holding more eligible liquid assets or changing their business models to reduce their liquid asset requirements.

Credit Conditions and Lending Standards

Banks' domestic loan books have continued to grow at a relatively modest pace in recent quarters, despite a pick-up in business credit (Graph 2.6). As discussed in the 'Household and Business Balance Sheets' chapter, households' demand for credit remains restrained as they continue to consolidate their balance sheets; growth in financial institutions' lending to households slowed a little to an annualised rate of around 4 per cent in recent months compared with 4½ per cent in the second half of 2011. Following a number of years of below-system growth, the smaller Australian-owned banks have recently recorded a stronger rate of growth in household lending to now be broadly in line with the major banks. After contracting over much of the past three years, financial institutions' lending to businesses has picked up in recent months, to an annualised growth rate of around 6½ per cent, driven by the major and foreign-owned banks.

According to industry liaison, household and business credit growth is expected to remain fairly subdued for some time because of weak demand. If this proves correct, banks could struggle to achieve



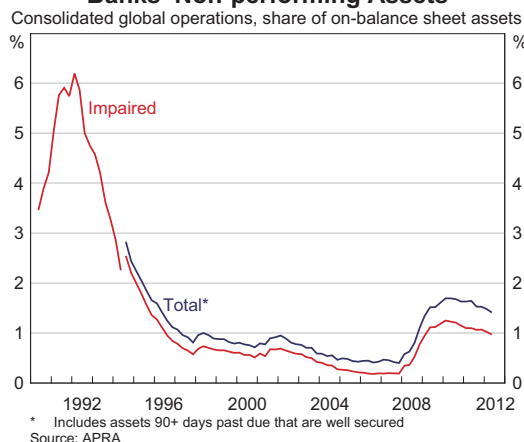
the rate of profit growth they were accustomed to in previous decades of rapid credit growth. In this environment, it would be undesirable if banks responded by loosening their lending standards or imprudently shifting into new products or markets in a bid to boost their balance sheet growth. While lending standards have eased somewhat since 2009, over the past year they appear to have been largely unchanged. Recently, some banks have been adjusting their assessments of borrower's repayment capabilities by shifting to a new data source on estimated living expenses, but the net effect of this on the overall availability of credit is likely to be minor (for more details, see the 'Household and Business Balance Sheets' chapter).

Asset Performance

Banks' asset performance has gradually improved over the past two years but remains weaker than in the years leading up to the 2008–2009 crisis. On a consolidated group basis, the ratio of non-performing assets to total on-balance sheet assets has declined from a peak of 1.7 per cent in mid 2010, to 1.4 per cent in June 2012 (Graph 2.7). The improvement over this period was mostly driven by a fall in the share of loans classified as impaired (i.e. not well secured and where repayment is doubtful), while the share of loans classified as past due (where the loan is in arrears but well secured) declined only slightly.

Graph 2.7

Banks' Non-performing Assets

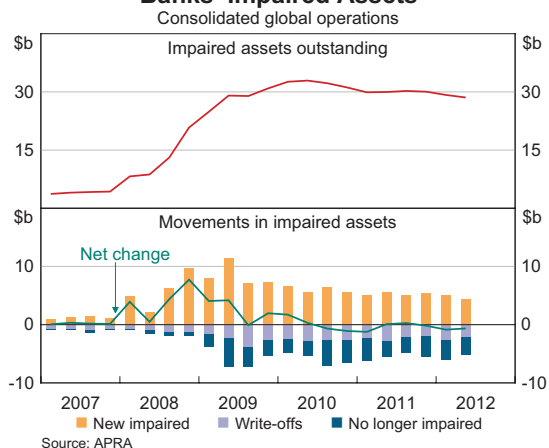


In recent years, quarterly inflows of newly impaired assets have been at a higher level than prior to the crisis, which helps explain the sluggish decline in the impaired assets ratio (Graph 2.8). Liaison with banks indicates that commercial property exposures have been a key driver of this elevated flow of new impairments, though loans to other sectors have also contributed, including agriculture and retail trade. As discussed in the 'Household and Business Balance Sheets' chapter, some businesses have been facing pressures over the past few years. If these uneven business conditions continue, the flow of newly impaired assets could remain elevated for some time, though it may not return to pre-crisis levels in any case given that the years leading up to the crisis were characterised by buoyant asset valuations.

Consistent with the industry liaison, commercial property exposures continue to account for a large share of the impaired assets in the banks' domestic business loan portfolios (Graph 2.9). Over the six months to June, the value of banks' impaired commercial property loans declined by about 13 per cent to \$8 billion, partly due to sales of troubled exposures. Around 4½ per cent of banks' commercial property exposures are still classified as impaired, down from a peak of over 6 per cent in 2010. Looking forward, pressures on valuations, particularly in non-prime locations, could lead to

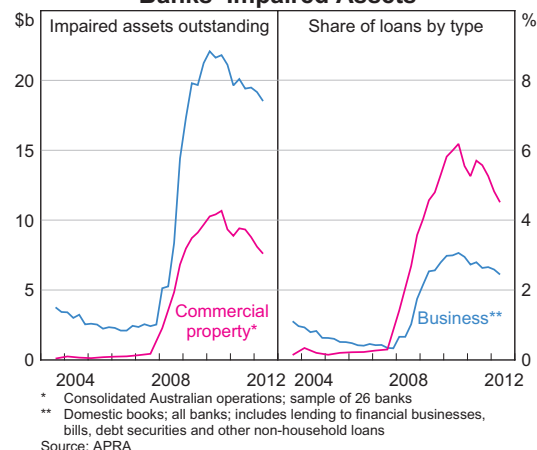
Graph 2.8

Banks' Impaired Assets



Graph 2.9

Banks' Impaired Assets

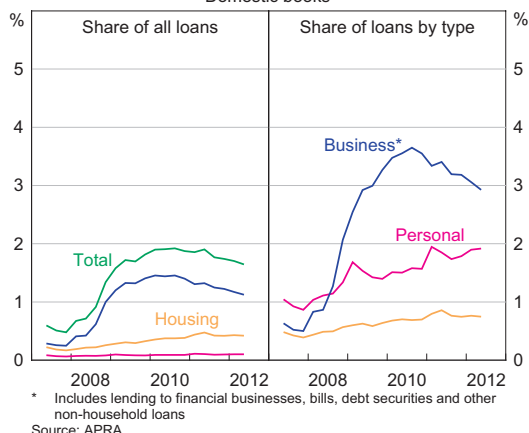


further losses from banks' troubled commercial property exposures.

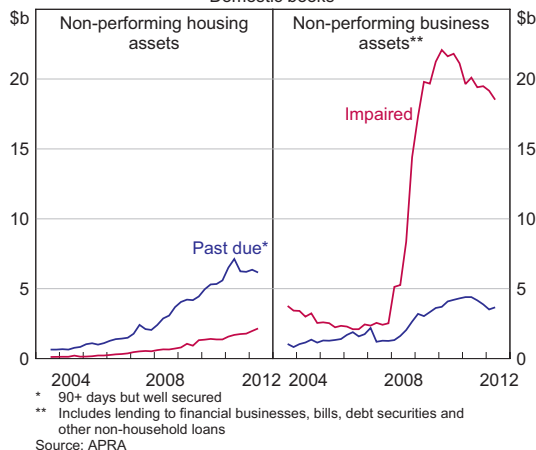
For banks' overall domestic business loan portfolios, the non-performing share stood at 2.9 per cent in June, down from 3.2 per cent in December 2011 (Graph 2.10). The bulk of these non-performing business loans are classified as impaired rather than past due, and may therefore generate future write-offs (Graph 2.11).

More detailed data from the major banks' Basel II Pillar 3 disclosures show that, on a consolidated group basis, business loan impairment rates

Graph 2.10
Banks' Non-performing Assets
Domestic books

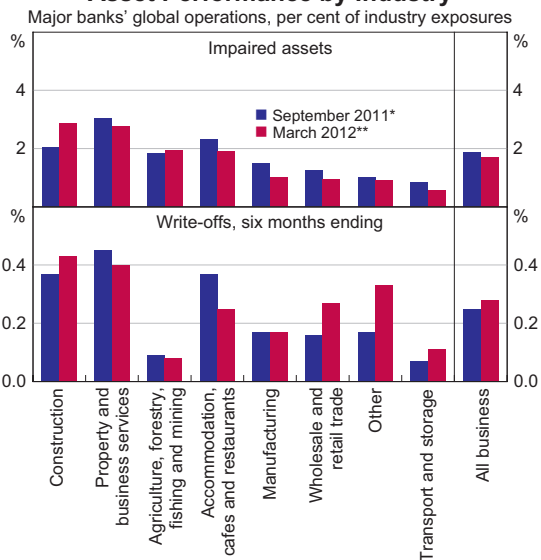


Graph 2.11
Banks' Asset Performance
Domestic books



declined across most industries during the six months to March 2012 (Graph 2.12). A notable exception was loans to the construction industry, where the average impairment rate increased fairly sharply over this period. Although the construction industry now has the highest impairment rate of all industries, it accounts for only a small share, around 4 per cent, of the major banks' total business loans. Other industries with above-average impairment rates include property and business services (incorporating commercial property), agriculture, forestry, fishing and mining, and accommodation,

Graph 2.12
Asset Performance by Industry
Major banks' global operations, per cent of industry exposures



* December 2011 for CBA
** June 2012 for CBA
Source: Banks' Basel II Pillar 3 reports

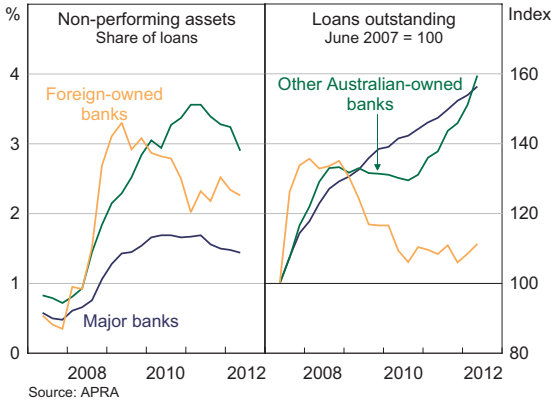
cafes and restaurants. These data also show that the average business loan write-off rate increased slightly during the six months to March 2012, with the property and business services, and construction industries continuing to have relatively high write-off rates.

Asset performance in the banks' domestic mortgage portfolios has been fairly steady in recent quarters. The share of the banks' domestic housing loans that is non-performing remained around 0.7 per cent over the six months to June, after falling slightly in the second half of 2011 (Graph 2.10). Within this, the share of past-due loans has declined a little since its peak in mid 2011, while the share of impaired loans has continued to edge up slowly, consistent with the weakness in housing prices in some parts of Australia (Graph 2.11). Further declines in housing prices could result in more impaired housing loans, though recent indicators suggest that prices are beginning to stabilise in many regions.

The improvement in banks' domestic asset performance over the first half of 2012 was broad based across the industry (Graph 2.13).

Foreign-owned banks, along with the smaller Australian-owned banks, continue to have weaker asset performance than the major banks, in large part due to problems in their business loan portfolios. The non-performing assets ratio for credit unions and building societies (CUBS) rose a little over the six months to June but remains much lower than that for the banks. Compared with banks, CUBS make a larger share of their loans to households, so it is not surprising that their overall asset performance is better. But this also means the recent weakness in the housing market may have a bigger effect on their loan portfolios.

Graph 2.13
Banks' Asset Performance and Lending
Domestic books



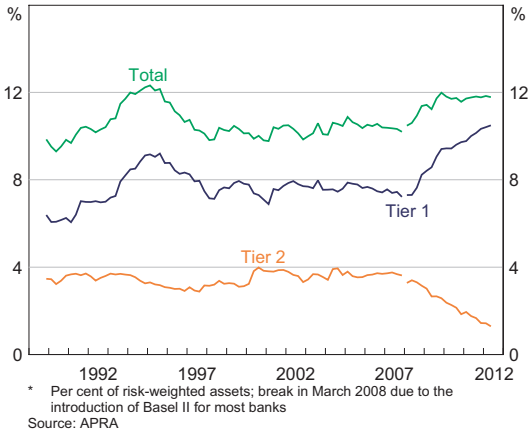
Banks' non-performing overseas assets were steady at around 0.3 per cent of their consolidated assets in the year to June, after peaking in mid 2010 at 0.4 per cent. However, the performance of the banks' overseas assets has been mixed across countries in recent quarters. For the banks' New Zealand operations, which account for about 40 per cent of their foreign exposures, asset performance has improved over recent quarters and should continue to do so if the better economic conditions in New Zealand persist. In contrast, the actual and expected asset performance of the banks' UK operations, which represent around 20 per cent of their foreign exposures, remain weaker given the fragile UK economy.

Capital and Profits

The Australian banks have continued to strengthen their capital positions over recent years, helping improve their resilience to shocks. Their aggregate Tier 1 capital ratio rose further over the first half of the year, to 10½ per cent of risk-weighted assets, up from about 8½ per cent in mid 2009 (Graph 2.14). This increase has been broad based, with most individual banks reporting increases in their Tier 1 capital ratios in the range of 1 to 3 percentage points in the past couple of years. This reflects the increased emphasis on Tier 1 capital and that some Tier 2 instruments will not qualify as capital under Basel III. The banks' aggregate Tier 2 capital ratio has continued to decline in recent quarters as banks have chosen not to replace most of their maturing subordinated debt. As a result, the total capital ratio has not risen as much as the Tier 1 ratio in recent years, but it is still relatively high at 11.8 per cent in June 2012. CUBS have maintained their higher capital ratios, consistent with their less diversified business models and different corporate structure; their aggregate Tier 1 capital ratio stood at 15.7 per cent in June 2012.

After issuing large amounts of new equity in 2008 and 2009, most of the growth in banks' Tier 1 capital in recent years has been organic, mainly through earnings retention. Banks' stock of retained earnings

Graph 2.14
Capital Ratios*
Locally incorporated banks

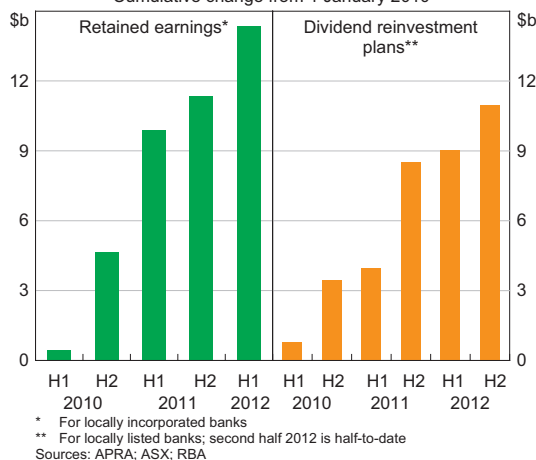


* Per cent of risk-weighted assets; break in March 2008 due to the introduction of Basel II for most banks
Source: APRA

has increased by \$14 billion since early 2010, contributing close to 1 percentage point (or 70 per cent) of the increase in their Tier 1 capital ratio over this period (Graph 2.15). At the same time, banks have been adding to their stock of ordinary equity through dividend reinvestment plans (DRPs). Over the past couple of years, around \$11 billion of equity has been issued to existing shareholders through these plans. Many banks have removed the caps on equity available through DRPs since early 2007 in an effort to enhance their capital raising flexibility. Over the past couple of years, most major banks have either removed or reduced the discounts on ordinary equity offered through their DRPs. Modest growth in risk-weighted assets over the past few years, mainly as a result of subdued credit growth and a gradual shift in the portfolio towards lower-risk assets, has also made it easier for banks to increase their capital ratios.

Graph 2.15
Capital Raisings

Cumulative change from 1 January 2010

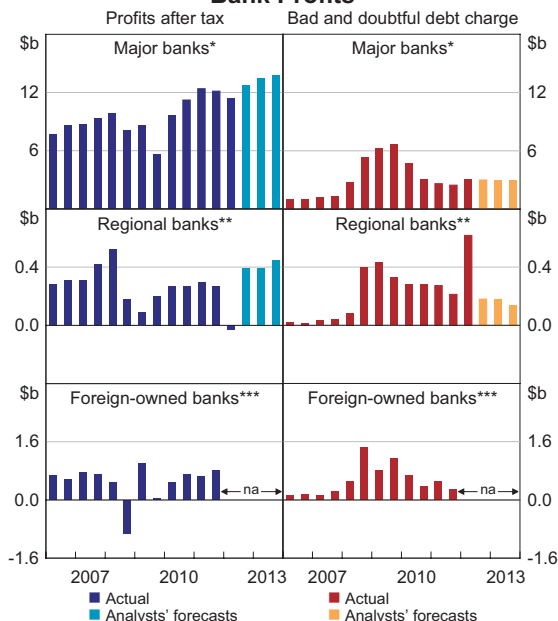


The upcoming Basel III capital requirements place greater emphasis on core capital than under Basel II, so banks are likely to continue building up their equity capital given the positive outlook for bank profit levels. Though the measurement of capital under Basel II is not strictly comparable to Basel III, the significant increase in the Tier 1 capital ratio over the past few years already puts the banks in a

good position to meet the first stage of the Basel III requirements that are being phased in from 2013. For the larger banks, APRA expects the necessary remaining increase in capital should be able to be met through earnings retention policies.

As noted, Australian banks have generally continued to post strong profits in recent reporting periods, though the rate of growth has slowed compared with the past few years. In their latest half-year results, the four major banks recorded an aggregate headline profit after tax and minority interests of around \$11 billion (Graph 2.16). This was about \$0.1 billion (1 per cent) higher than in the same period a year earlier, after adjusting for the effect of a large, one-off tax benefit in 2011. Revenue growth over the year was steady at around 5 per cent. After falling over the past few years and supporting profit growth, bad and doubtful debt charges look to have troughed. They rose by about 15 per cent in the latest half-year

Graph 2.16
Bank Profits

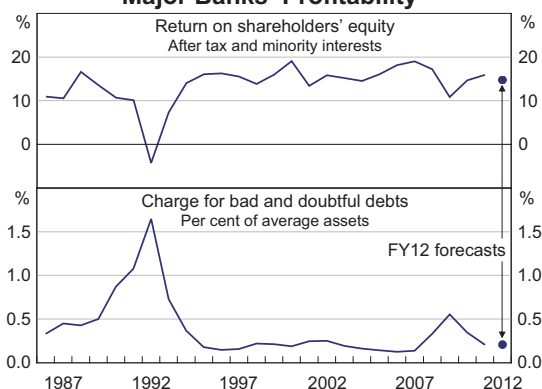


* ANZ, NAB and Westpac report half yearly to March and September, while CBA reports to June and December
 ** Suncorp Bank, and Bendigo and Adelaide Bank report half yearly to June and December, while Bank of Queensland reports to February and August
 *** All results are half year to June and December
 Sources: APRA; Credit Suisse; Deutsche Bank; Nomura Equity Research; RBA; UBS Securities Australia; banks' annual and interim reports

reporting period, mostly due to higher impairments in the major banks' UK operations.

For the major banks, analysts are generally expecting bad and doubtful debt charges to level out over the next year. With revenue growth tending to match growth in operating expenses, the banks are continuing to focus on improving cost efficiency; a number of them have announced cost-cutting initiatives, including targeted staff cuts in some areas. Looking ahead, analysts are currently forecasting the major banks' aggregate profits to rise by about 12 per cent in the next half-year reporting period and their return on equity to remain around 15 per cent, similar to the past two years (Graph 2.17).

Graph 2.17
Major Banks' Profitability*



* From 2006, data are on an IFRS basis; prior years are on an AGAAP basis
Sources: Credit Suisse; Deutsche Bank; Nomura Equity Research; RBA; UBS Securities Australia; banks' annual and interim reports

In aggregate, the regional Australian banks reported a loss after tax and minority interests of \$30 million in their latest half-year results, with profits falling by around \$300 million compared with the same period a year earlier. The main contributor to the loss was a sharp rise in charges for bad and doubtful debts to \$600 million, up from \$200 million in the previous reporting period. This was mainly due to losses on commercial property loans at a couple of the banks that are more exposed to the weaker Queensland market. Analysts expect the losses to be a once-off, with the asset performance of the regional banks forecast to stabilise in the next reporting period

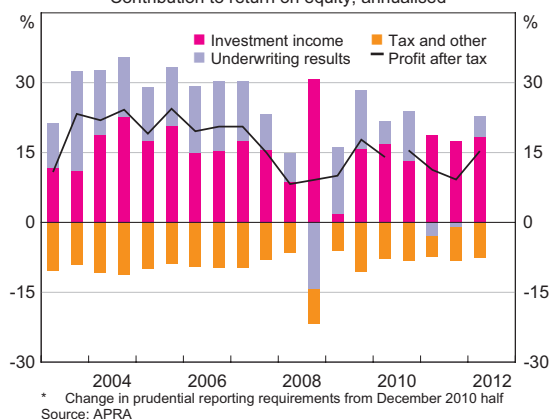
and charges for bad and doubtful debts to decline. Other authorised deposit-taking institutions have had relatively small changes in their profitability: the foreign-owned banks and building societies increased their aggregate profits in their latest half-year results while credit unions' profitability fell slightly.

Overall, while banks' profitability is expected to remain high, a continuation of the modest credit growth environment and higher funding costs is likely to constrain future profit growth. The challenge for the industry in this environment will be to avoid taking on unnecessary risk or cutting costs indiscriminately in a bid to sustain unrealistic profit expectations, as this could ultimately sow the seeds of future problems.

General Insurance

The general insurance industry remains well capitalised at 1.8 times the minimum capital requirement, similar to the levels of the past couple of years. Underwriting results have returned to more normal levels after the adverse effects of the natural disasters in late 2010 and early 2011. However, return on equity for the industry, at around 15 per cent annualised for the June half 2012, remains below the average over the years leading up to the global financial crisis (Graph 2.18). A challenge for the industry is operating in a low-yield environment, which is related to the ongoing difficulties in Europe and weak growth in the major countries' economies. Because insurers invest premium revenue in generally low-risk assets to cover future claim payments, the lower the investment yield, the more premium that needs to be collected to cover future claims, particularly for 'long-tail' insurance products such as liability insurance. While the insurance industry has been increasing premium rates in response to higher reinsurance costs (related to the recent natural disasters), competitive pressures may limit insurers' capacity to raise premium rates further. In this environment, it would be undesirable if insurers sought to improve their profitability by

Graph 2.18
General Insurers' Performance*
 Contribution to return on equity, annualised



investing imprudently in riskier, higher-yielding investments.

The profits of lenders' mortgage insurers (LMI) have come under some pressure from the recent weakness in the residential property market, which has boosted the number and average size of claims, although their overall profitability over the past year remains solid. A prolonged or more severe downturn in property prices combined with higher housing loan arrears (for instance, due to higher

unemployment), would increase claim rates further and reduce profits. As noted earlier, though, recent indications are that the housing market is beginning to stabilise. The LMI sector holds about 1½ times a minimum capital requirement that is designed to absorb losses from a very severe housing market downturn. While the LMIs are currently rated highly by the major rating agencies, Moody's is in the process of reviewing its global methodology for rating LMIs, which could result in changes to the Australian LMIs' ratings. Prior to this review, it had flagged the Australian LMIs for a possible downgrade, noting its concern that their capital buffers would be tested in the event of a severe downturn in the Australian residential property market.

Managed Funds

Unconsolidated assets under management in the Australian funds management industry grew by 9 per cent in annualised terms over the six months to June, to \$1.9 trillion, more than reversing a decline over the second half of 2011 (Table 2.3). The rise was driven by superannuation funds, whose assets under management rose by 12 per cent in annualised terms, and now represent over 70 per cent of the unconsolidated assets of managed funds.

Table 2.3: Assets of Domestic Funds Management Institutions
 As at end June 2012

	Level \$ billion	Share of total Per cent	Six-month-ended annualised change	
			Dec 11 Per cent	Jun 12 Per cent
Superannuation funds	1 349	72	-4.6	12.1
Life insurers ^(a)	235	12	-5.2	5.6
Public unit trusts	260	14	-10.9	-3.6
Other managed funds ^(b)	38	2	-0.6	4.2
Total (unconsolidated)	1 882	100	-5.6	8.8
<i>Of which:</i>				
Cross investments	382	-	-10.2	5.9
Total (consolidated)	1 500	-	-4.3	9.5

(a) Includes superannuation funds held in the statutory funds of life insurers

(b) Cash management trusts, common funds and friendly societies

Source: ABS

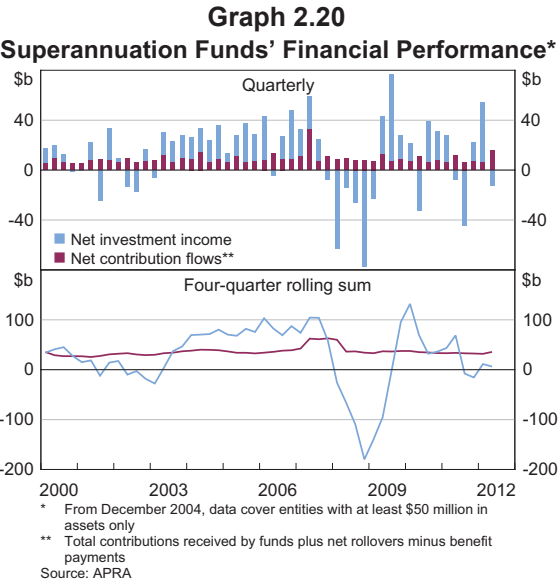
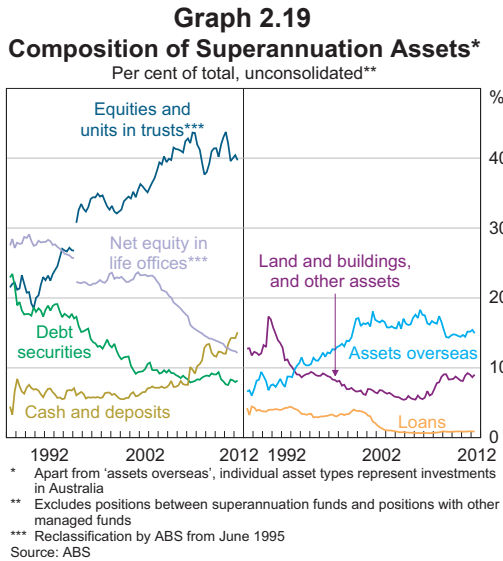
Superannuation funds' holdings of cash and deposits continued to grow, in part reflecting the heightened demand for safer assets in an uncertain investment environment (Graph 2.19). Even so, equities and units in trusts remain the largest component of superannuation investments at 40 per cent of funds under management. About 20 per cent of their equity holdings or 6 per cent of their total assets are invested in equity issued by Australian banks. Superannuation funds' holdings of domestic bank equity have increased over the past two decades, and now account for over one-quarter of the equity issued by banks. However, the share of total superannuation assets that is invested in domestic bank equity has remained steady over the past decade.

Partly because they have quite long investment horizons, superannuation funds have been willing to purchase Australian bank equity even during times of market strain; their net purchases during the height of the global financial crisis exemplifies this behaviour. Indeed, throughout the past decade or so, superannuation funds have been more often net purchasers of bank equity than net sellers during

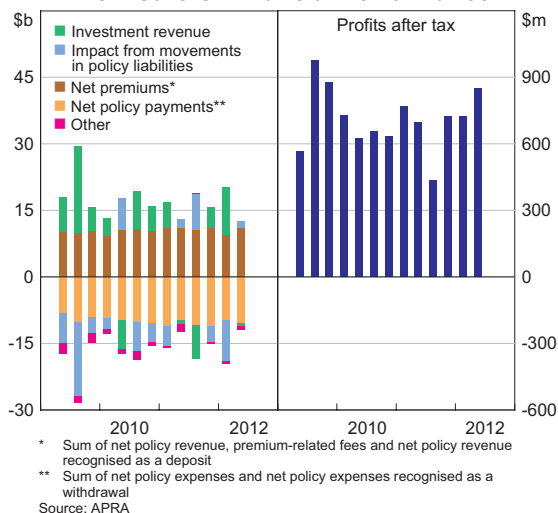
periods when bank share prices have declined. As the size of the superannuation industry grows, these funds should continue to be a valuable source of new capital, should it be required, for the banking sector in stress conditions.

Against a backdrop of relatively steady contribution inflows, superannuation funds have experienced mixed investment performance in recent years associated with the volatility in global financial markets (Graph 2.20). A recovery in share markets during the March quarter this year drove a pick-up in funds' investment returns, but this was partially offset by declining share prices in the June quarter. Over the year to June, superannuation funds in aggregate recorded little net investment income.

Life insurers' funds under management rose by about 6 per cent in annualised terms in the six months to June 2012. Their profitability increased over the six months to June, aided by investment returns on fixed-interest securities (Graph 2.21). The life insurance industry remained well capitalised at 1.4 times the minimum requirements as at June 2012.



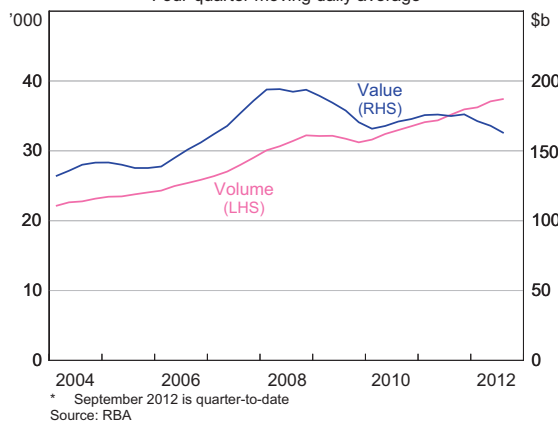
Graph 2.21
Life Insurers' Financial Performance



Financial Market Infrastructure

The Reserve Bank's high-value payments settlement system, RITS, continued to operate smoothly during the past six months, settling around 4 million payments worth \$16 trillion – equivalent to around 25 times the value of GDP over the same period. The average daily volume of transactions was 5 per cent higher in the six months to September compared with the previous half year (Graph 2.22). In contrast, the value of transactions settled in RITS declined

Graph 2.22
RITS Settled Payments*
Four-quarter moving daily average



by 6 per cent over the same period to an average of \$158 billion per day – the lowest level since the March quarter 2006, and about 22 per cent below the peak in the March quarter 2008.

Settlement of low-value transactions, such as direct entry, consumer electronic (cards-based) payments and cheque transactions, also occurs in RITS through a daily batch, rather than on a real-time gross settlement basis. To increase the efficiency of the settlement of these transactions, the Bank recently implemented a new system, the Low Value Settlement Service (LVSS). The settlement of direct entry transactions was successfully migrated to the LVSS in May 2012, followed by the clearing system for consumer electronic transactions in August. The clearing system for cheques is expected to migrate in October. Currently, an average of about \$17 billion of transactions are settled using the LVSS each day.

The two ASX central counterparties, ASX Clear and ASX Clear (Futures), use a variety of risk controls to centrally manage counterparty risk in Australia's main exchange-traded equities and derivatives markets. These include the collection of margin from participants, and pooled risk resources (i.e. 'default funds'). Variation or mark-to-market margin is collected from participants on a daily basis to cover the risk exposure resulting from actual changes in the value of their positions. Initial margin is also collected for participants' new positions, to cover the potential future risk exposure from changes in the value of a defaulting participant's positions between the last collection of variation margin and the time at which the positions can be closed out. Currently, at ASX Clear, initial margin is collected on derivatives positions only, but ASX Clear is working towards introducing routine margining of equities in the 2012/13 financial year.

Margin held at the central counterparties provides an indication of the aggregate risk of open positions held in normal market conditions. Margin held on derivatives positions cleared by ASX Clear continued to decline over the first half of 2012, as

turnover decreased and margin rates were adjusted downwards to reflect the more benign market conditions (Graph 2.23). Margin rates for derivatives cleared by ASX Clear (Futures) were also lowered during the first half of 2012, but this was more than offset by increased turnover in the most commonly traded contracts, resulting in higher margin held overall.

While some margin rates have been lowered, this has been done incrementally. The central counterparties have maintained margin rates for the most commonly traded contracts above the rates recommended by their backward-looking statistical models, reflecting caution as to the possible effects on market volatility of ongoing international uncertainty, and to guard against frequent procyclical changes in margin rates.

