

RBA tries to boost confidence in the domestic financial sector

Key Points

- Like its Central Bank counterparts, the RBA has endorsed the broad nature of the proposed US\$700 rescue package for the US financial sector.
- Without this support, the RBA has warned of the risk of a deepening of the damaging feedback loop between the financial sector and the real economy.
- Despite the extremely challenging global environment, the RBA has given the local financial sector a relatively clean bill of health.
- Non-performing loans have increased, but remain low at 0.7% of banks' assets as at June 2008. The most notable increase in arrears has been in the business sector, mainly due to pressures in the commercial property sector. Non-performing housing loans have risen to 0.4%, a very low level by current international standards.
- But of course the banking sector (and the Australian economy) is not unscathed. The RBA notes that sharp falls in bank share prices and a widening of funding spreads has prompted banks to, amongst other things, tighten lending standards. This slowdown in credit growth, in our view, will continue to drag on growth and presents a downside risk to the local economy next year.

Trying to avoid the negative feedback loop

The RBA has used today's semi-annual Financial Stability Report to endorse US policy-makers attempt to stabilise the US financial system. In its clearest statement yet about the serious risks now facing the global economy, the RBA has warned that "...the smooth functioning of the credit supply process has been disrupted in some countries. This has increased the risk of a damaging feedback loop running from the financial sector to the economy and back to the financial sector."

In welcoming the support efforts by US authorities, the RBA warns that the depth of the destruction will depend largely on the direction of US property prices and the restoration of investor confidence in banks themselves.

Australian financial system "well-placed"

With this in mind, the essence of today's report does aim to provide some much needed confidence in the local financial system. The RBA acknowledges that local banks have clearly been severely affected by global developments, mainly through tumbling share prices and increased funding costs. Unsurprisingly, the extremely challenging global environment has prompted notable behavioural changes amongst local banks, including a tightening of some credit standards and increased liquidity hoarding.

Nevertheless, today's report highlights that Australia's financial sector has entered the current period of global market turmoil on a relatively strong footing. The RBA notes that in contrast to many other industrialised economies, the Australian banking sector remains profitable, soundly capitalised (with an aggregate total capital ratio of 10.6% at June 2008)

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and with high credit ratings. The RBA notes that the Australian banking sector's direct exposure to the troubled US economy is small. Less than 10% of Australian-owned banks' total foreign claims are to the US, with lending to the US household sector only small.

The RBA concludes that *"while the Australian financial system has not been completely insulated from developments abroad, it is weathering the current difficulties much better than many other financial systems."*

Problem loans are small, but rising

Today's report states that despite an increase in arrears, the ratio of local banks' problem loans to total assets in the Australian banking sector is still below the average since the mid-1990s, and well-below the extreme distress of the early 1990s recession.

Problem loans in Australia are also low by international standards (just 0.7% of total assets at June 2008). While there has been a rise in provisioning charges, the RBA notes that banks' total charges for bad and doubtful debts for this year will be around 0.3% of assets. This is well below a peak of over 1.5% during the early 1990s recession.

In particular, the housing loan book in Australia appears much stronger. The proportion of housing loans that are in arrears by 90 days or more was 0.41% at June 2008. While this was slightly higher than at the end of 2007, it is the same level of arrears as a year ago. In contrast, in the US 30+ arrears have risen to 6.4% in June 2008 from 4.3% in mid-2005. Such arrears have increased to 2.9% up from 2.3% in the UK and to 2.5% from 1.2% in Spain.

Unfortunately for NSW, problem housing loans are much higher in this region than in other states, having risen from around 0.2% of prime loans in 2003 to more than 0.8% now. This largely reflects the relatively weak NSW economy, including falling house prices in some regions. However, the RBA also notes that looser lending standards, particularly by newer lenders in western Sydney, has also contributed to higher default rates.

That housing default rates are still below 1% should be of some comfort, given the significant challenges (including higher interest rates and declining wealth) that households have faced this year. Default rates on credit cards and other personal loans have also increased only slightly and still remain relatively low at around 1.2% and 1.0% respectively. Importantly, growth in credit card cash advances is low and the proportion of credit card balances according interest has remained steady (at around 78%).

Relative to households, there has been a greater run-up in ratio of non-performing loans to the business sector. Arrears to incorporated businesses have risen to 1.2% in June from 0.7% at end of last year. However, this increase is largely due to a small number of exposures to highly geared companies with complex financial structures and exposures to the commercial property sector. Arrears on loans to unincorporated businesses have barely changed.

More generally for the business sector, the RBA suggests that fundamental indicators paint a relatively healthy picture of business balance sheets overall. In particular, strong profitability in recent years means that business are less reliant on external funding to fund investment, which should help going forward as we enter a period of lower profitability. This should also assist many businesses with the higher cost of servicing interest. That said however, the aggregate interest-servicing ratio for larger and unincorporated businesses has now risen to the highest level since the early 1990s. And there are some pockets of stress, with some highly geared companies, particularly those holding utility and infrastructure, vulnerable to current tight financial conditions.

The RBA also believes the fall out for the local market from the AIG bail-out in the US will be limited. Partly, this is because AIG has only small operations in Australia. Moreover, while the industry's net underwriting result has weakened, the RBA

Non-performing loans at Australian banks are low by historical and international standards

The housing loan book looks healthy with the exception of some pockets in NSW

There has been a greater run-up in arrears on business loans

...although it remains confined to a few highly geared corporates and those exposed to the commercial property sector

assesses that the aggregate capital position of Australia's general insurance industry is sound.

That was then

Australia remains well placed to weather the storm...

Today's report confirms the Australian financial sector has entered the current period of turmoil in much better shape than many of its peers. Indeed, this is why Australian banks have all been able to retain their AA ratings as other (traditionally revered) counterparts have slipped.

...but the situation is not without risks

However, it is important to note that this is an historical document. Conditions in financial markets have toughened even in the few days since this report was finalised and the downside risks to global and local economic growth continue to mount. While today's report shows the Australian financial sector is a long way from the depths currently being plumbed in the US, there can be little doubt that significant local challenges remain.

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