AUSTRALIAN BANKERS' ASSOCIATION

Fact Sheet

A strong banking system

Overview

Australia has a long history of stable and safe banks.

One indicator is the fact that virtually no Australian has lost their deposit in an Australian bank in the last 100 years. The last failure where depositors' money was lost occurred in 1931 when depositors in the Primary Producers Bank of Australia lost a negligible amount of their deposits.

Another indicator is that not a single dollar of taxpayers' money has been demanded or required to reimburse bank depositors in over one hundred years. Even during the severe 2007 financial crisis, when banks were failing around the world, Australia's banking system remained stable and open for business.

Australian banks are prudently managed using international best practice, well regulated and, for these reasons, retain amongst the highest credit ratings in the world.

Savers can rest assured their bank deposits enjoy a high degree of safety. When making payments, customers can be confident the system is very safe and secure.

Bank failure

Australia has not had a thorough bank failure in the modern era*, and so has not experienced the fallout from a collapse first-hand.

We need to look overseas for examples of how things can go terribly wrong. Here are some of the episodes in other countries that stand out:

1970	USA	US Penn Central Bank – collapse of market liquidity
1974	Germany	Herstatt – bank failure following foreign exchange trading losses
1984	USA	Continental Illinois Bank – failure following loan losses
1985	Canada	Regional banks – failures following loan losses
1993	France	Credit Lyonnais Bank – crisis
1995	UK	Barings Bank – collapse due to trading losses
1995	USA	Daiwa Bank – record trading losses
1996	Japan	Banking system – crisis following loan losses
2007	UK	Northern Rock
2008	USA	Bearn Sterns
		Lehman Brothers

In a number of these cases, depositors lost their savings or the taxpayer had to subsidise the loss.

*Bank failure is here defined as an episode where ordinary depositors lose their money. It is recognised that Australian banks have gone through periods of turbulence. The late 1980s and early 1990s was a transitional period characterized by volatility. The State Banks of South Australia and Victoria collapsed. The loss of public confidence took its strongest turn when Pyramid Building Society went into insolvency, costing the Victorian Government $900m to bail out. Credit Union and Friendly Societies also faced problems. That said, the fact remains that Australia has not faced widespread social dislocation as a result of a financial crisis since at least the 1890s depression.

How does a strong banking sector benefit the community?

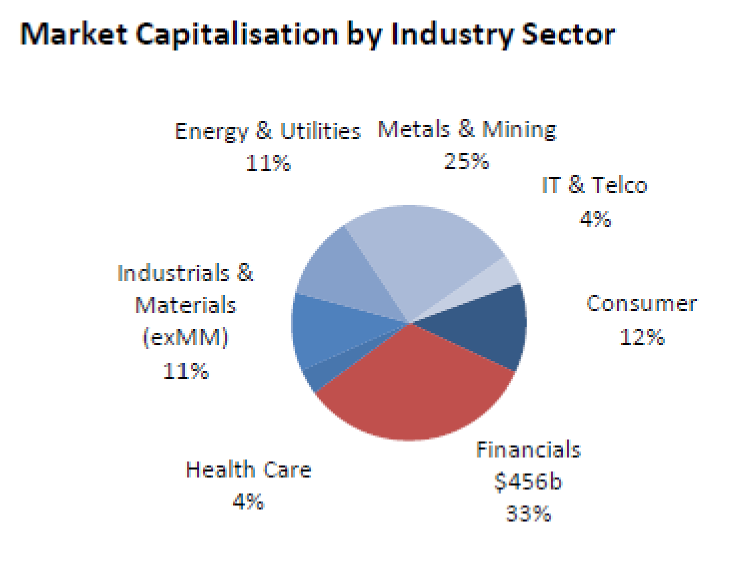
The investment and retirement plans of numerous Australians are closely tied to the vigour of the banking system.

Investment and Financial Services Association (IFSA) estimates that approximately nine million Australians have an interest in Australian-listed stocks through wealth management or superannuation funds. The overwhelming majority of those funds would include bank stocks because of the need to provide balance to individual's fund portfolios as bank stocks account for 25% of the ASX index.

Furthermore, based on banks' share registry figures, an estimated 2.1 million direct shareholders benefit from dividends.

Banks are also pivotal to the Australian capital market as part of the 'Finance and Insurance' category that today makes up around 33% of market capitalisation on the Australian Stock Exchange (ASX) – see Figure 1, the largest single segment. This slice has increased from around 20% in the early 1990s.

Figure 1: Stock Market Capitalisation – by industry



Source: Australian Stock Exchange

A reliable banking system is also vital so that ordinary depositors' savings are safe.

Australian depositors, who entrust their money to banks, have good reason for confidence.

Ultimately, the key long-term community benefit of a strong banking system is that the two core services banks provide – making loans from depositors' money and operating transaction accounts - will be maintained efficiently.

Regarding transactions, Australia's population is just over 22 million, yet each day on average, Australian retail customers make 14million retail payments.

Regarding loans, households and business depend on billions of dollars a year for their economic livelihood (see box).

Illustration: community reliance on bank lending

The following simulation shows the potential vulnerability of businesses and jobs to even a modest change in bank lending:

→ in the calendar year ending December 2003, banks loaned the business sector $642 billion dollars, equal to 34 per cent of total outstanding loans;

→ so if banks tightened lending by just 10 per cent, Australian businesses would be short $64 billion for investment funds;

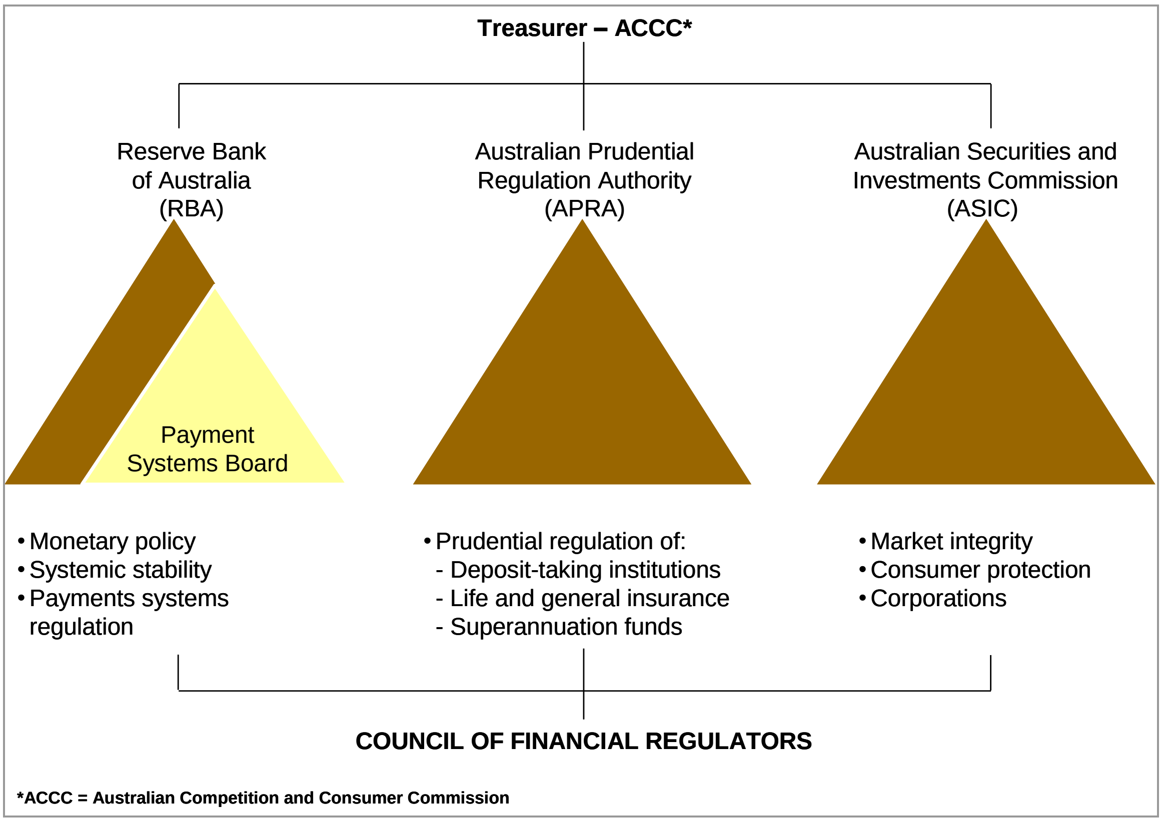
→ to give an idea of what this contraction in credit could mean for the community, assume that half of the bank credit issued was used to hire employees at an average annual wage of $53,000;

. . . then the cut in credit of $19 billion equates to over 605,000 Australian jobs lost.

Robust prudential standards

Australia has a sound surveillance system that reflects a considered approach by government to prudential supervision and is based upon the international standards put forward by the Basel Committee of the Bank for International Settlements (Figure 2).

Figure 2: Australia's Financial Regulatory Framework



Source: KPMG 1998 Financial Institutions Performance Survey; Axiss Australia

The interlocking yet independent roles of the regulators are a stronghold of the Australian system.

Since 2004, the Reserve Bank has been issuing a document titled 'Financial Stability Review.' It was the first of its kind in Australia, summarising relevant information for the assessment of an economy's financial stability. The RBA have published this document every six months since then. It has consistently argued that Australia's banking system is in a strong position, particularly relative to most other countries.

Through the 2008/09 financial crisis, Australia's banking system remained profitable and continued to lend and operate services on a near normal basis.

As this Fact Sheet is being drafted, the world is facing a great deal of economic uncertainty over financial stability in Europe. A number of notable European countries have very large debt-to-GDP ratios and are struggling to convince financial markets that they have sound plans to reduce these debt ratios.

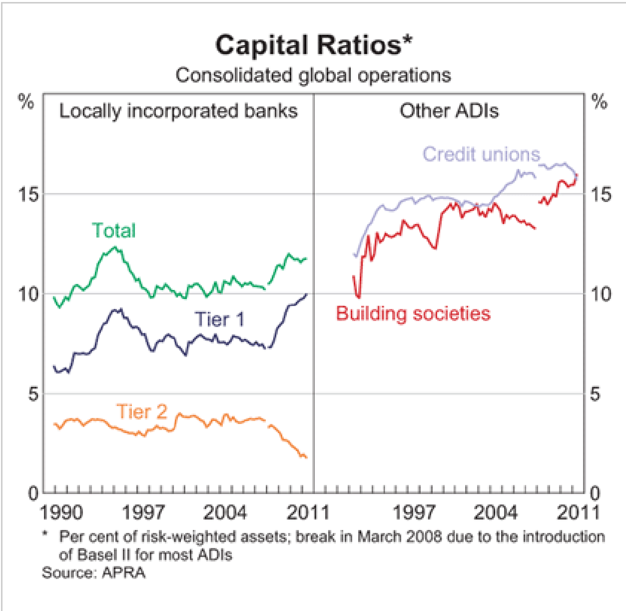
Amongst this uncertainty, Australia's financial system remains resilient, indeed in a stronger position than it was before the financial crisis, except for a slightly higher level of bad debts. The situation was recently well summarised in the RBA's Financial Stability Review:

> *"Relative to its pre-crisis position, though, the Australian banking system is better placed to cope with such adverse shocks. It has higher levels of capital, makes less use of short-term wholesale funding and makes greater use of deposits as a source of funding.*

> *Bank profitability continues to improve following the financial crisis, largely due to falls in charges for bad and doubtful debts.*
>
> *"On the other hand, should conditions deteriorate materially, the effect on the banking system would occur from a somewhat weaker starting position on asset quality than had been the case at the beginning of the crisis. Despite the favourable macroeconomic environment and low unemployment in Australia, the proportion of non-performing assets on banks' balance sheets remains close to its recent peak, though it is well below the levels seen in the early 1990s and those currently experienced in many other developed countries."*[1]

As noted, Australian banks have currently very strong capital levels. Capital is vital for stability as it provides a pool of money capable of absorbing losses. Of particular importance in terms of absorbing losses is Tier 1 Capital, this is the highest quality capital, made up of predominantly of ordinary shareholder equity. Currently, Tier 1 capital levels are the highest they have been since at least the early 1990s – see figure 3.

Figure 3: Bank capital ratios



Source: RBA Chart Pack, October 2011

[1] Reserve Bank of Australia, Financial Stability Review, September 2011.

Project Panama

As part of their supervision of banks, regulators conduct 'stress tests' to assess banks' capacity to endure economic downturns. Australia's banks have come through with flying colours.

In 2003, the Australian Prudential Regulation Authority (APRA) released 'Project Panama', a major data collection and analysis exercise to test the resilience of Australia's banks to a very significant hypothetical increase in mortgage defaults and property price declines.

The scenario assumptions used were as follows:

1. over a one year period, house prices decline by 30 per cent; and
2. mortgage defaults increase to an average of 3.5 per cent – this is very tough considering the 20-year average home mortgage default is 0.12 per cent a year.

After collecting the data and subjecting the bank housing loan portfolios to the stress tests using the above assumptions, APRA announced its findings in a speech by newly elected Chairman, John Laker, on 9th October 2003[1]. Dr Laker said:

> *"The core finding is that a substantial housing market correction, if one were to eventuate, would not of itself be cause for undue alarm as far as the strength and stability of Australia's ADI sector is concerned. This finding gives considerable comfort that the ADI sector remains able to protect depositor safety over the medium to longer term."*

[1] 'The resilience of housing loan portfolios - APRA's "stress test" results', speech by APRA Chairman, John Laker, 9 October 2003. Available on APRA web site www.apra.gov.au.

Since the landmark Project Panama Study, APRA and individual banks have built a systematic and ongoing process of stress testing. Stress testing now forms an integral and regular part of bank risk management.

Corporate governance

International ratings of Australian banks' governance are impressive.

Australian banks do consistently well in terms of international benchmarks and our prudential governance framework is recognised as greatly superior to other countries.

Prudent lending

In August 2003, in what was believed to be world-first standards in respect of lending, defaults and protection of guarantors, banks adopted a revised *Code of Banking Practice* after extensive consultation with key stakeholders and the Code's independent reviewer.

The revised Code builds significantly on the earlier edition (1993) and among the new provisions:

- small business is included for the first time;

- provision of information for prospective guarantors before they commit to guaranteeing someone else's debt;
- provision of important information on credit card chargebacks;
- helping customers cancel direct debit authorities;
- with the customer's agreement, to try and help the customer suffering financial difficulties with their bank loan, overcome those difficulties;
- a lending standard that before a bank offers or gives a credit facility or increases an existing credit facility, the bank will exercise the care and skill of a diligent and prudent banker in selected and applying their credit assessment methods and in forming their opinion about the customer's ability to repay the facility.

The Australian Bankers' Association's (ABA) *Code of Banking Practice* stands out both in scope and the specific customer benefits it provides compared with those in place in the United Kingdom, Canada, New Zealand and Hong Kong.

In March 2004, the ABA launched a range of industry initiatives to assist bank customers in managing their household finances. The ABA and member banks listened to community concerns over problems associated with debt, and put in place some initiatives to assist in addressing a number of the concerns about credit card marketing. While recognising Australia currently has very low levels of credit default, indicating the vast majority of Australians manage credit well, the banking industry wants to provide improved services where possible.

These initiatives are:

(1) Banks have agreed to provide information in letters to customers offering increased credit card credit limits; on how much more customers have to pay each month, if they take up the offer. The customer will then easily be able to assess the increased repayments needed if they use the additional credit.

(2) Advice to customers, included in marketing material, that if their personal circumstances have recently changed, for example loss of employment, or are likely to change, for example maternity leave, they should <u>not</u> accept any credit card credit limit increase offer, and should immediately contact their bank.

(3) A capacity for individuals to opt for a lower credit card credit limit than the increase their bank has offered. For example, a customer can opt for a $1000 increase in preference to the $2000 limit increase offered.

(4) An industry benchmark that any ABA member bank customer can reduce their credit card credit limit:

    (a) If the bank has a telephone facility to do this – within 24 business hours of receipt of request;

    (b) In any other case – within 48 business hours of receipt of request.

National credit laws

Supporting the banks own prudent lending practices, the Federal Government has taken over responsibility for the regulation of credit. As part of this, there is an enhanced obligation on credit providers to ensure they make loans which are suitable for consumers.

This obligation, while causing some interpretation difficulties, is really just a statement of best practice and assists in giving consumers confidence that they when they go to a bank they will be offered an appropriate product.

System security

In May 2004, the banks announced that staff was being seconded to the Australian High Tech Crime Centre (AHTCC) as part of a new team to continue the fight against cybercrime.

The banking industry has been concerned about ghost websites, phishing (e-mail scams) and Trojans (computer programs which conceal hidden programming which infects computers and are used by criminals to access or destroy other people's data) which have targeted customers who use online banking. It is important to note that the banks’ systems have not been hacked but criminals have tried to lure customers into revealing confidential information so that accounts can be defrauded.

The team is one element of a new National Response Plan developed by the ABA’s Fraud Taskforce and the AHTCC.

The National Response Plan is a protocol which formalises the response to cybercrime. Organisations now work cooperatively with the AHTCC, share intelligence about online fraud issues, within the bounds of the law, and act quickly to progress investigations and protect consumers.

The ABA and banks have been active in educating bank customers about good practice when transacting on the Internet. This advice includes: installing a firewall, installing and keeping up-to-date anti-virus software, and advising never to reveal confidential Internet banking passwords or logon details to anyone. Security guides are available from banks and can be read on banks’ websites. Banks have also been distributing a video which gives useful tips to small businesses on how they can protect themselves against credit card fraud.

In addition, the ABA has an industry taskforce to set standards for enhanced authentication of online transactions. The ABA will develop these standards, with its member banks, who will assess the level of risk associated with each transaction and establish appropriate mechanisms to verify the customer’s identity. While the new Taskforce works on the industry standards, the ABA member banks will continue development of their own authentication initiatives. Adoption of these standards will be a mark of quality, and customers should be encouraged to check if their bank adopts these standards.

Healthy profitability

A strong banking sector requires solid levels of profitability.

The Australian banking sectors' profit margin is consistently robust, by world standards. At around 1.3% of assets, Australian banks' profit ratio is at higher end of world rankings. While this has much to do with Australia's superior economic performance over the last twenty years, it is also testament to the quality of bank management.

Figure 4 shows Return of Asset (ROA) date for a range of countries between 2001 and 2010. On average Australia's banks have returned an average of ROA of 1.36%, only marginally lower than that achieved by US banks.

Figure 4 – Comparison of profits by selected country

	Pre-tax profits										10-year average	Ave pre-GFC
	2010	**2009**	**2008**	**2007**	**2006**	**2005**	**2004**	**2003**	**2002**	**2001**		
Australia	1.14	0.93	1.01	1.40	1.54	1.52	1.48	1.63	1.49	1.47	**1.36**	1.52
Austria	0.67	0.63	0.46	1.12	1.48	0.85	0.78	0.61	0.46	0.44	**0.75**	0.77
Canada	1.01	0.72	0.47	1.08	1.22	1.01	1.22	1.08	0.61	0.91	**0.93**	1.01
France	0.45	0.18	0.04	0.41	0.73	0.76	0.65	0.68	0.45	0.67	**0.50**	0.66
Germany	0.17	-0.11	-0.46	0.26	0.43	0.38	0.13	0.04	-0.01	0.14	**0.10**	0.19
Italy	0.37	0.36	0.27	0.88	1.05	1.23	0.87	0.80	0.67	0.90	**0.74**	0.92
Japan	0.30	0.29	-0.16	0.59	0.46	0.66	0.34	0.11	-0.55	-0.69	**0.14**	0.06
Netherlands	0.04	-0.15	-0.61	0.16	0.48	0.58	0.50	0.69	0.46	0.62	**0.28**	0.56
Spain	0.95	0.88	1.07	1.44	1.37	1.15	0.89	1.61	1.01	1.20	**1.16**	1.21
Sweden	0.61	0.34	0.67	0.89	0.96	0.90	0.91	0.87	0.69	0.83	**0.77**	0.86
Switzerland	0.66	0.21	-1.75	0.38	0.80	0.66	0.73	0.42	0.12	0.41	**0.26**	0.52
United Kingdom	0.25	-0.04	-0.05	0.76	0.90	0.87	0.95	1.24	1.06	1.24	**0.72**	1.04
United States	1.02	0.42	0.28	0.96	1.71	1.93	1.84	2.20	1.89	1.52	**1.38**	1.85

Source: Bank of International Settlements

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