# The Global Credit Crisis: Why Have Australian Banks Been So Remarkably Resilient?

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## Abstract

*This paper identifies a number of key factors that explain the remarkable resilience of the Australian banking sector in the face of the Global Financial Crisis, with a view to gleaning lessons for other countries' banking systems. It is argued that in Australia a culture of prudent lending prevails: banks are soundly capitalised, with a well-diversified and stable funding base, and with a track record of healthy profitability. The industry is independently recognised for its sound corporate governance, and official oversight of banks is diligent. Importantly, the separation of commercial banking from social-assistance policy has been maintained, unlike in the US.*

## Introduction

Almost unnoticed in the northern hemisphere, Australian banks have weathered the storm of the Global Financial Crisis remarkably well. While not immune to many of the commercial consequences flowing from the crisis, the stability of the banking sector in Australia contrasts sharply with the US and UK, which have seen bank collapses and bailouts supported by taxpayers' funds. Despite the rises in funding costs resulting from the turbulence, Australian banks' lending portfolios are exhibiting sound quality and low defaults.

This paper documents the remarkable strength and stability of the Australian banking industry in the current climate, in comparison with international peers, and provides explanations for why this is so. Australia's banking system versus overseas peers represents an interesting study in contrasts, a study that may provide clues for policymakers and bankers as to how to avoid a repeat of the crisis in the future.

## Performance of Australian banks during the current crisis

### No bailouts of Australian banks

Table 1 provides an overview of government support packages during the 2008 financial crisis, by country. Bank 'bailouts' proper are summarised in the first column. Almost all of the countries listed enacted a package to rescue individual

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banks, defined as injecting capital directly into those firms. The few notable exceptions include Australia. In some of the bailout countries, the bank bailouts are extensive (US, UK, Germany, Netherlands) and in one case the banks have been nationalised (Iceland). By contrast, no individual Australian bank had to be explicitly rescued during the crisis, no banks in Australia have closed, and the Government has not had to nationalise banks, as has occurred elsewhere. Accordingly, the first column in Australia's case is nil.

**Table 1: Summary of 2008 official support measures of banks**

| Country | Capital injection | Purchase of assets | TOTAL | TOTAL (US$) | TOTAL (% GDP) |
|---|---|---|---|---|---|
| Australia | - | A$8 | A$8 | 5.5 | 0.5 |
| Austria | €15 | - | €15 | 21.9 | 5.1 |
| Belgium | €4.4 | €2.5 | €6.9 | 9.7 | 1.8 |
| Canada | - | CAD$25 | CAD$25 | 20.5 | 1.3 |
| France | €41 | - | €41 | 57.6 | 1.9 |
| Germany | €130 | - | €130 | 182.8 | 4.8 |
| Greece | €5 | - | €5 | 7.0 | 1.9 |
| Iceland | Nationalised | Nationalised | 100% | n.a. | n.a. |
| Italy | As needed | - | As needed | n.a. | n.a |
| Netherlands | €46.8 | - | €46.8 | 65.8 | 7.1 |
| Spain | - | €50 | €50 | 70.3 | 4.1 |
| South Korea | - | KRW1,000 | KRW1,000 | 0.79 | 0.1 |
| Switzerland | CHF6 | US$60 | US$60+ | 65.6 | 13.3 |
| USA | US$250 | US$450 | US$700 | 700 | 4.9 |
| UK | £50 | - | £50 | 73.5 | 2.6 |

Source: Bank of England, *Financial Stability Report* 24, 27 October 2008.
Figures are in billions of currency shown, except final column.
Note: Japan did not announce a bank bailout package in 2008. On 27 January 2009, it allocated funds purportedly worth almost 27 trillion (US$301 billion) to dealing with the fallout from the financial crisis, but this encompassed a wide range of industrial firms' assets such as corporate debt, stocks, commercial paper and derivatives. Japan had earlier conducted a bailout of its banking sector in the 1990s and early 2000s.

To put the favourable Australian situation of no bank bailouts in perspective, consider the lengths to which the major rescue packages needed to go:

- beginning 8 September 2008 the US announced the US$700 billion Troubled Asset Relief Program (TARP), of which around US$250 billion was earmarked for direct bank bailouts; to date, 52 banks have been funded by the program, including the likes of Citibank ($45 billion), Bank of America ($45 billion), JP Morgan Chase ($25 billion), Wells Fargo ($25 billion), Goldman Sachs ($10 billion), Morgan Stanley ($10 billion), Merrill Lynch ($10 billion), Bank of New York Mellon ($3 billion), State Street ($2 billion), as well as US Bancorp, Suntrust, Washington Mutual, National City, Countrywide, First Horizon, Indy Mac, Wachovia, PNC, Regions Financial, Fifth Third, and Keycorp.
- on 8 October 2008 the UK authorities announced a comprehensive and system-wide support package that addressed directly weaknesses in UK

> banks' balance sheets and involved a government-supported recapitalisation scheme for UK banks, involving big name institutions Abbey, Barclays, HBOS, HSBC Bank plc, Lloyds TSB, Nationwide Building Society, Royal Bank of Scotland, and Standard Chartered; for example, a capital injection into RBS, HBOS and Lloyds amounted to £37 billion.

Regarding the US response, it is significant to observe that this is the second major US taxpayer bailout in 20 years, the other resulting from the US Savings and Loans crisis in the 1980s. Assessing the October UK bailout package, the Bank of England said that this represents 'the largest UK government intervention in financial markets since the outbreak of the First World War'.[2]

The second column in Table 1 relates to government purchases of financial instruments, not financial institutions, and is therefore a different notion from a 'bailout', strictly defined. While forming part of the wider notion of government crisis support, the second column therefore does not equate to a bank 'bailout'. According to the Organisation for Economic Cooperation and Development (OECD), which recently published a terminology of bank crisis-resolution methods, the notion of bailouts is institution-based, referring always to the purchase of firms, not financial instruments, where such firms' viability is dependent on some form of public assistance, through which 'their failure is forestalled'.[3] On this definition, Australia has not seen a true taxpayer bailout of a private commercial bank in the wake of the Global Financial Crisis. Whilst a modest amount is shown in the second column for Australia, it relates to the purchase of non-conforming housing loans (so-called low-doc loans, approved without the full substantiation of the borrowers' capacity to service the repayments) with virtually all of these loans made by non-bank lenders.[4]

The table does not show government guarantees of bank deposits, and some might argue that such measures amount to a bailout. In particular, in November 2008 the Australian Government introduced legislation supporting the Commonwealth's guarantee scheme for large deposits and wholesale funding, having previously announced the plan in October. The Australian Prudential Regulation Authority (APRA) supported the move. It is significant to note that the Government was careful to make clear that it had arrived at its decision on depositor guarantees not to head off potential bank losses but, rather, to 'promote financial system stability in Australia, by supporting confidence and assisting ADIs (authorised deposit-taking institutions) to continue to access funding at a time of considerable turbulence' (http://www.guaranteescheme.gov.au/). Bank

[2] Bank of England 2008: 32.

[3] On 26 September 2008, the Australian Government announced its intention to purchase $4 billion of residential mortgage-backed securities (RMBS) to support competition in the market for housing finance following the dislocation of the Australian RMBS market. In October, the Government announced it would invest a further $4 billion in RMBS, bringing the total investment to $8 billion.

[4] Lewis 2008.

deposits were *already* safe — legislatively speaking — with or without the Government's new guarantee, as there was already in place a depositor priority scheme under the *Banking Act* which gives depositors first claim on the assets of a bank. Notwithstanding this, practical advantages of the new guarantee scheme include the removal of potential uncertainty around the timeliness of payment in the event of a claim, and removal of the competitive distortion created by foreign wholesale-funding guarantees previously enacted by governments overseas. Indeed, the Government noted this second point in its announcement, saying that the measures 'are also designed to ensure that Australian institutions are not placed at a disadvantage compared to their international competitors that can access similar government guarantees on bank debt'. The move was long overdue in Australia, because 19 other countries had previously issued guarantees in support of their banking systems and, in the words of APRA, 'we are not talking about "banana republics" here: most of these are developed countries with established banking systems'.[5] Those countries include the US, UK, Canada, France, Spain, Belgium, Italy, New Zealand and Germany. The action by the Australian Government, although no doubt affected in its timing by the crisis, can therefore be understood structurally in terms of international competitive neutrality.

## No US and UK-style liquidity emergency

One way to gauge the stability of a nation's banks is to look at the orderliness of the financial markets they serve and with which they are inextricably linked, especially during a crisis. This is because conditions in banking are intimately connected with those in broader money and capital markets. As defaults on US sub-prime mortgages escalated in 2007 and 2008, losses spilled over into wholesale financial markets because valuation uncertainty rose sharply and spread like a contagion, not only for mortgages but also across a broad range of financial instruments. Bid-ask spreads in secondary money markets widened and prices came to embody significant discounts for illiquidity and uncertainty, as investors with cash became reluctant to lend while prices may yet fall further. In some countries, this created a severe liquidity shortage, and a challenge for the local central bank.

Table 2 shows a comparison across countries of the extent to which each nation's central bank was forced to take extraordinary steps as the 2007–08 liquidity crisis developed.

[5] Lumpkin 2008.

**Table 2: Special measures taken during the financial turmoil by central banks**

| | AUS | CAN | EUR | UK | US |
|---|---|---|---|---|---|
| Exceptional fine-tuning | √ | √ | √ | √ | √ |
| Exceptional long-term open-market operations | √ | √ | √ | √ | √ |
| Front-loading of reserves in maintenance period | | | √ | | |
| Change in reserve requirements/targets | | | | √ | |
| Change in the standing lending facility | | | | | √ |
| Broadening of eligible collateral | √ | √ | | √ | √ |
| Broadening of counterparties | | | | √ | √ |
| Introducing or increasing securities lending | | | | √ | √ |

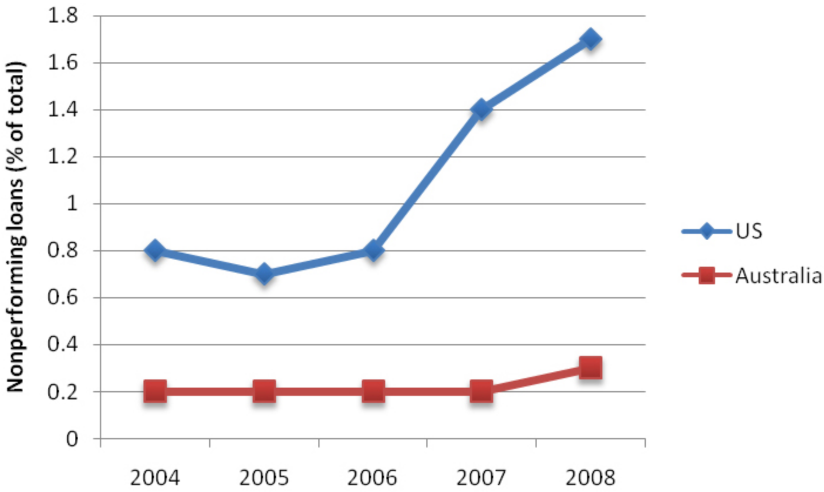
Source: Committee on the Global Financial System, 'Central bank operations in response to the financial turmoil', CGFS Papers No 31, Bank for International Settlements (BIS), July 2008.
Key: AUS = Australia, CAN = Canada, EUR = Euro area (European Central Bank), UK = United Kingdom, US = United States. 'Exceptional fine-tuning' refers to central bank actions in the money markets being markedly more frequent than usual. 'Front-loading of reserves' means pre-emptive injections of liquidity by the central bank to anticipate shortages before they occur.

As Table 2 shows, Australia's central bank, like its overseas counterparts, was moved to enact special measures to protect market liquidity. Equally, however, the extent of these measures was notably more limited in Australia's case than was required in the US and the UK. Consistent with the BIS interpretation of the data, the money-market instability seen in the Australian case was relatively modest, and this is because the market volatility in the US and UK had its roots in failed bank lending in those markets, an experience not shared in Australia.

## Australian banks have avoided abnormal loan write-downs

There has been a marked deterioration in credit quality and credit standards by mortgage lenders in the United States over a number of years. This is affecting the performance of both sub-prime loans and prime mortgage loans in the US. Figure 1 compares the trends in loan quality, in Australia and the US. Impaired loans rose sharply in the US in 2007 and again in 2008. By comparison, Australian impaired loans are holding much steadier, around their pre-crisis level.

### Figure 1: Trends in non-performing loans




Source: International Monetary Fund, *Global Financial Stability Report*, October 2008
Data show loans in 60+ days' arrears, as a percentage of total loans outstanding. US figures cover all FDIC-insured institutions. Figures are the ratio of impaired assets to total assets, excluding loans covered by collateral.

Table 3 provides a breakdown of Australian arrears by loan category, and Table 4 shows US loan write-offs by category, including official projections of the ultimate impact of the credit crisis.

### Table 3: Arrears (90+ days) by loan category—Australia

| | Housing | Personal | Business |
|---|---|---|---|
| % arrears Sept 2008 | 0.41 | 1.10 | 1.43 |

Source: Reserve Bank of Australia

### Table 4: US write-downs by loan category — US$B (% of amount outstanding)

| | Amount outstanding | Losses at Oct 2008 | | Projected ultimate write-downs | |
|---|---|---|---|---|---|
| Housing | 4,700 | 170 | (3.6) | 265 | (5.6) |
| Personal | 1,400 | 45 | (3.2) | 80 | (5.7) |
| Business | 3,700 | 110 | (3.0) | 195 | (5.2) |

Source: International Monetary Fund, *Global Financial Stability Report*, October 2008

The Australian banking system continues to experience a low level of problem loans.

Contrast this with the United States banking system. As reported in Table 4, by October 2008 US financial institutions had incurred losses on their portfolio estimated at more than 3 per cent, and International Monetary Fund (IMF) projections suggest that, by the time the dust settles from the current crisis, US write-downs will amount to as much as 5–6 per cent of the banking system. European banks are also looking at huge loan write-downs. Europe has incurred an estimated US$220 billion in loan losses, according to the latest IMF estimates. This equals around two-thirds of the US losses to date of US$325 billion. Australian banks, by contrast, have avoided having to make major loan write-downs.

**Table 5: Arrears (30+ days) — by country**

| | % arrears |
|---|---|
| Australian mortgages | 1.13 |
| UK Prime RMBS | 2.90 |
| US mortgages | 6.40 |

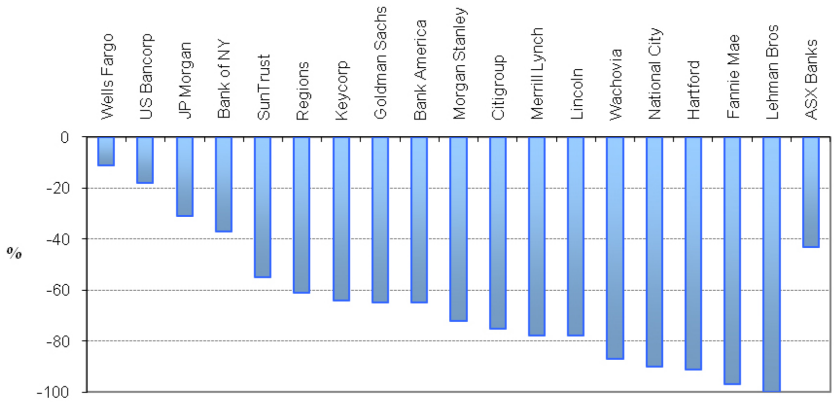
Source: Reserve Bank of Australia.
Data are for September 2008.

Focusing on housing loan arrears, shown by country in Table 5, we see that they are running much higher in the US, with the 30+ days arrears rate on all mortgages up from 4.3 per cent in 2005 to 6.4 per cent in 2008. In the UK, the share of rated (prime) securitised mortgages that are 30+ days in arrears edged from 2.3 per cent in 2005 up to 2.9 per cent in 2008.

## Share prices of Australian banks comparatively resilient

On the back of the financial troubles, banks' share prices slumped across the globe, and Australian banks were no exception. Yet the share prices of Australian banks have proven significantly more resilient, given the circumstances, than most overseas peers. Figure 2 shows the drop in stock prices of US versus Australian banks in 2008, the year of the crisis. In Australia, the ASX Banks Index fell 43 per cent. When this statistic is placed against the American context, the Australian banks' share-price fall sits at the low end of the spectrum. Most US banks and mortgage lenders recorded far steeper declines, in the range 60–90 per cent.

**Figure 2: Fall in share prices during the crisis — US versus Australian banks**




Sources: *Federal Reserve Bank of St. Louis Review* 91(1), January 2009; Australian Stock Exchange
Figures are for the 12-month period to November 2008.

Furthermore, over the longer horizon, Australian banks' share prices have consistently outperformed many of their international peers.

## Australian banks have not been downgraded

Despite the financial turbulence, Australian banks continue to be rated strongly by international credit-rating agencies. Unlike many major financial institutions abroad, only one Australian-owned bank (SuncorpMetway, downgraded from Aa3 to A1 in March 2009 by Moody's) has had its credit rating downgraded since the crisis set in. Each of the largest Australian banks is rated *AA* by Standard & Poor's, with these ratings having recently been re-affirmed. Australia has four out of the 19 highest-rated banks in the world. Of the world's largest 100 banks, only a handful have stronger ratings. Each of the larger Australian banks is rated *Aa1* by Moody's. Indeed, Moody's has *upgraded* several Australian banks since the crisis began (ANZ, Bank of WA, National, St George: see Table 6) although in March 2009 the outlook for 'big four' banks was revised from stable to 'negative', in view of the weakening economy. The Reserve Bank of Australia recently observed that 'even in the current credit crisis … where Australia is, in one sense, more exposed than many other countries due to our heavy reliance on international funds, the strong credit ratings of our banks have ensured banks have maintained credit availability'.[6]

[6] Reserve Bank of Australia 2008.

**Table 6: Long-term credit ratings of Australian banks**

| | January 2008 | May 2009 |
|---|---|---|
| Adelaide Bank | A2 | A2 |
| ANZ Bank | A2 | Aa1 |
| Bendigo Bank | not rated | A2 |
| Bank of QLD | A2 | A2 |
| Bank of WA | Aa3 | Aa1 |
| Commonwealth | Aa1 | Aa1 |
| Macquarie Bank | A1 | A1 |
| National Bank | Aa2 | Aa1 |
| St George Bank | Aa2 | Aa1 |
| SuncorpMetway | Aa3 | A1 |
| Westpac | Aa1 | Aa1 |

Source: Moody's Investor Service

**Table 7: Recent rating downgrades of major overseas banks**

| | January 2008 | May 2009 |
|---|---|---|
| Bank America* | AA– | A+ |
| Barclays PLC* | AA | AA– |
| Citigroup* | AA– | A |
| Credit Suisse* | AA– | A+ |
| Deutsche Bank* | AA– | A+ |
| GoldmanSachs* | AA– | A |
| HSBC | AA– | AA- |
| JP Morgan* | AA– | A+ |
| MorganStanley* | A+ | A |
| Royal Scotland* | AA– | A+ |
| UBS* | AA– | A+ |
| Wells Fargo* | AA+ | AA |

Source: Standard and Poor's
S&P's scale is AAA, AA+, AA, AA–, A+, A, A– (L to R: high to lower ratings).
Asterisks indicate downgrades.

In contrast, on 17 December 2008 Standard and Poor's downgraded 11 major overseas banks (Table 7). Around 90 per cent of the overseas banks were downgraded, compared with 9 per cent in Australia's case.

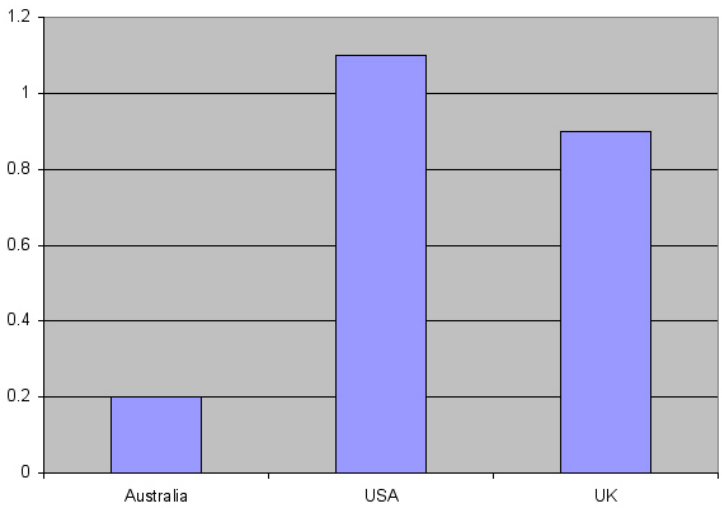
## Explaining the contrasting experience

The message that emerges from the above is that Australian banks stand out, compared with their northern counterparts: no bailouts needed, no liquidity emergency of US/UK proportions, no abnormal loan write-downs, no rating-agency downgrades, and unusually resilient share prices. There are a number of reasons for this.

## A culture of intermediation, not securitisation

Australian banks' lending practices are responsible, as demonstrated by portfolios that are now exhibiting sound quality and low defaults. Figure 3 compares loan quality across countries, in the year *prior* to the crisis.

**Figure 3: Non-performing loans 2007 (percentage of total bank loans)**




Source: International Monetary Fund, *Global Financial Stability Report*, April 2008

Australia's impaired loan ratio in the lead up to the crisis was the lowest in the world, at just 0.2 per cent of total loans outstanding. By comparison, major peers were significantly higher, notably the UK (0.9), US (1.1), France (2.8), Germany (3.4) and Italy (5.3). The explanation for Australian banks' high asset quality has to do with these structural differences and business culture:

- *Intermediation norm*: while securitisation has not been entirely absent from the Australian lending environment, intermediation is still by far the dominant model, particularly in mortgage lending. This has meant that incentives and risk-taking have not been de-coupled at the 'coalface' and Australia has not gone down the path of expanding loan volumes without paying adequate regard to risk.
- *prime lending focus*: the 'non-conforming housing loan' segment in Australia (the closest equivalent to the sub-prime market in the US) has remained very small, less than 1 per cent of outstanding mortgages — compared to about 12 per cent in the US.

An additional indicator of a nation's approach to lending is provisioning for bad and doubtful debts. Table 8 presents data by country on bank provisioning for the loan book, measured by the ratio of provisions to non-performing loans. A higher figure indicates safer provisioning against loan defaults.

**Table 8: Bank provisions against loan losses — by country (ratio of provisions to non-performing loans)**

| | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|
| Australia | 182.9 | 203.0 | 202.5 | 183.7 | 128.6 |
| Canada | 47.7 | 49.3 | 55.3 | 42.1 | 36.7 |
| France | 61.3 | 63.8 | 62.9 | 61.4 | ... |
| Japan | 29.9 | 31.2 | 28.1 | 28.8 | 26.4 |
| UK | 61.5 | 54.0 | 54.6 | ... | ... |
| US | 168.1 | 155.0 | 135.0 | 93.1 | 88.9 |

Source: International Monetary Fund, *Global Financial Stability Report*, October 2008
Figures for 2008 are latest available quarter.

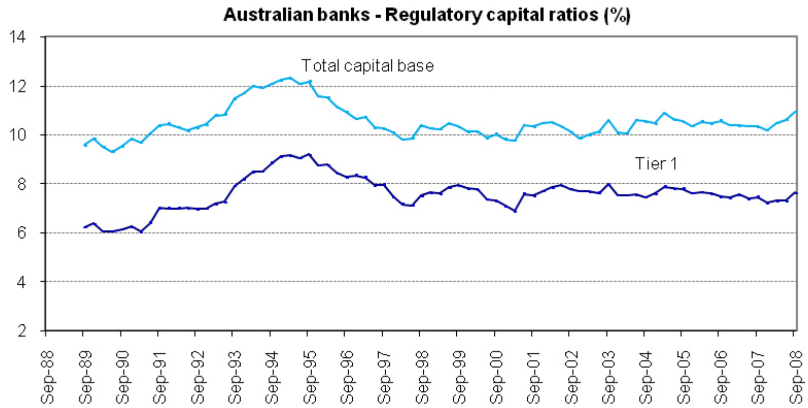
Since before the credit crisis, the provisioning of Australian banks has consistently been generous, exceeding the amount of impaired loans. Indeed, Australia is one of the few countries in the world running a provisioning ratio greater than 100 per cent, including in 2008, the crisis year. Australian banks' provisioning comfortably exceeds that of US banks and has typically run at four times that of UK banks.

## Australian banks are highly capitalised

Under the Basel II Framework, which came into effect in Australia from 1 January 2008, banks are subject to a prudential capital ratio (PCR) of 8 per cent of total risk-weighted assets. At least half of this capital must be held in the form of Tier 1 capital (the highest-quality capital components). That is, the minimum Tier 1 capital ratio is 4 per cent. These are global minimum requirements, and the Basel Committee on Banking Supervision has recently stated that it does not propose to raise these ratios during the global financial crisis.

As shown in Figure 4, Australian banks exceed the minimum capital requirements comfortably. Unlike many overseas counterparts, banks in Australia have not been forced to raise new capital to offset loan write-downs. Strong profitability has meant that retained earnings remain a key source of Tier 1 capital, with equity issues by larger banks adding to this over the past year.

**Figure 4: Bank capitalisation — Australia**




Source: Australian Prudential Regulation Authority

In November 2008, at the peek of the international credit crisis, APRA summed up the position this way: 'ADIs in Australia are meeting their capital-adequacy requirements and the ADI sector is sound and well-capitalised'.[7]

## A diversified and stable funding base

Australian banks traditionally raise their funds from two main sources: customer deposits (around 50 per cent) and wholesale funding, both short-term (25 per cent) and long-term (25 per cent), and in both the domestic and global markets. For most of this decade, banks' funding sources in most countries — and the cost of funding — were relatively predictable. In particular, total bank funding costs moved generally in tandem with movements in the cash rate of central bank. Since the global capital markets turmoil, however, funding for many financial institutions — particularly in the US, UK and Euro area — has become a matter of considerable uncertainty. Short-term funding costs have been unusually volatile, and long-term capital markets have become more expensive and investors more selective in choosing which institutions to lend to, resulting in elevated long-term funding costs with little sign of relief. Capital markets have been more difficult to access, issuance by banks around the globe has been abnormally low, and spreads are at high levels. For banks with a strong credit rating (that is, AA or A) seeking short-term funding, there is generally good liquidity in debt markets but prices remain elevated when compared with levels prior to the financial crisis. Banks rated BB or B are finding it more difficult to access longer-term funding and are concentrating more on short-term funds.

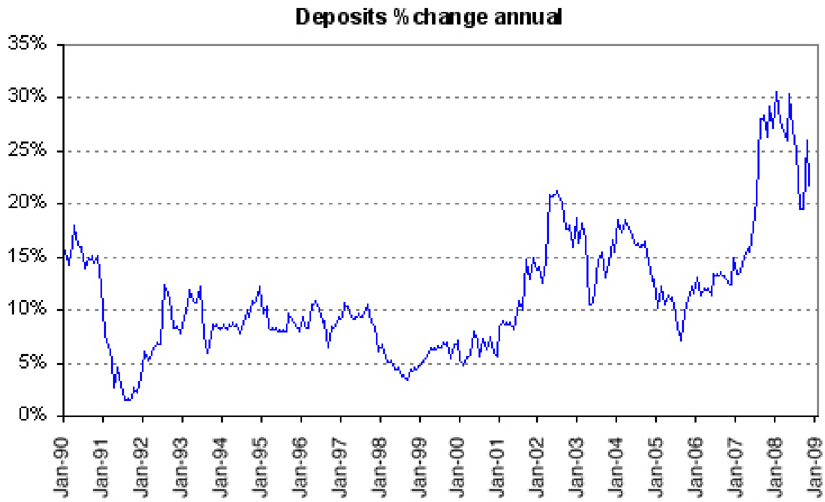
In this difficult environment, Australian banks have nevertheless fared better than many banks overseas. Along with most other financial institutions around

[7] Australian Prudential Regulation Authority 2008.

the globe, Australian banks have not been immune from the recent pressures. Nevertheless, in retail funding, Australian bank deposits have been growing rapidly since the turbulence began, increasing at an annual rate of about 20 per cent, the fastest growth for many years. Figure 5 confirms this positive scenario.

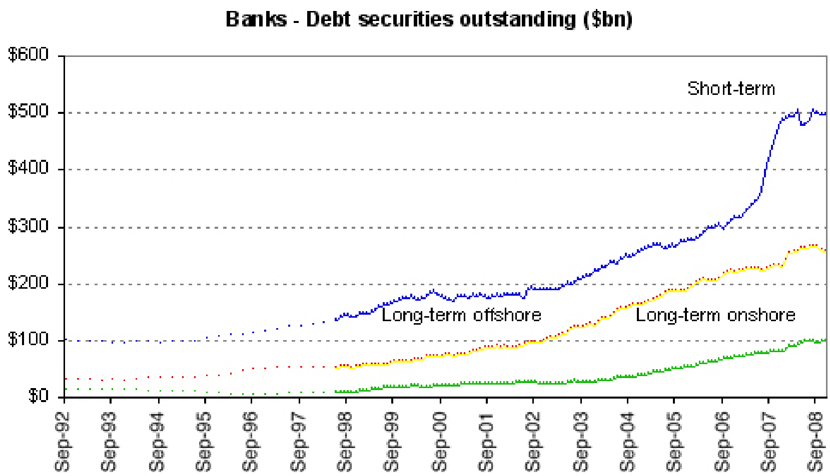
Equally importantly, Australian banks have continued to tap the wholesale funding markets, both domestic and international, as shown in Figure 6.

**Figure 5: Australian banks' retail funding**




Source: Australian Prudential Regulation Authority

**Figure 6: Australian banks' wholesale funding**




Source: Reserve Bank of Australia

While Australian banks may have had to pay more for funds, they have generally been able to obtain the funds they need to expand their balance sheets. The ability of Australian banks to continue to raise significant volumes of funds is a positive reflection of their underlying strength. Since November 2008, it can be argued that the Australian Government's 100 per cent guarantee of bank deposits and of wholesale term funding has contributed to supporting continued funding for banks. Equally, as the charts show, for the majority of 2007 and 2008 (as the crisis in credit markets was building and then climaxing), Australian banks held their own in funding circles without official assistance.

## Healthy profitability

Alongside low levels of problem loans with limited exposure to sub-prime assets, sound capitalisation, and a stable funding base, the Australian banking system exhibits sturdy profitability. Table 9 compares Australia with other countries using return on equity (ROE), a common a measure of profitability. It confirms that the condition of Australian banks before the credit crisis was one of healthy profitability. In comparison, both the UK and the US recorded weaker trend returns than Australia.

**Table 9: Bank profitability by country (return on equity %)**

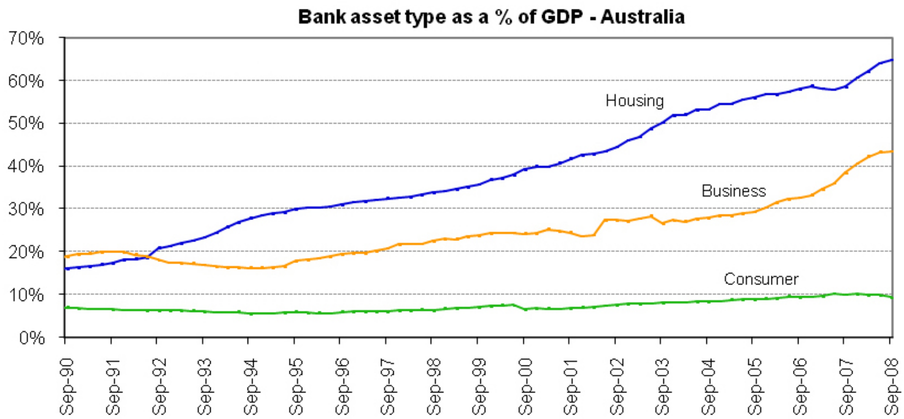
| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|
| Australia | 24.2 | 16.0 | 14.7 | 16.8 | 18.1 | ... |
| Belgium | 13.6 | 25.8 | 18.5 | 22.4 | 13.2 | ... |
| Canada | 14.7 | 26.7 | 14.9 | 20.9 | 16.1 | 6.3 |
| Denmark | 15.4 | 13.7 | 16.3 | 17.1 | ... | ... |
| Finland | 11.3 | 12.4 | 10.1 | 11.1 | 15.6 | ... |
| Germany | -1.5 | 1.9 | 9.2 | 7.5 | ... | ... |
| France | 8.5 | 10.6 | 11.8 | 15.5 | 9.8 | ... |
| Italy | 9.3 | 9.3 | 9.7 | 11.4 | 9.7 | ... |
| Japan | -2.7 | 4.1 | 11.3 | 8.5 | 3.2 | 6.1 |
| Netherlands | 14.8 | 16.8 | 15.4 | 15.4 | 18.7 | ... |
| Norway | 9.6 | 14.6 | 18.0 | 15.7 | 15.9 | 8.3 |
| Spain | 13.2 | 14.1 | 16.9 | 19.9 | 19.9 | ... |
| Sweden | 12.3 | 14.6 | 17.4 | 18.0 | 17.0 | 15.9 |
| Switzerland | 11.7 | 14.3 | 18.0 | 17.7 | ... | ... |
| UK | 10.9 | 10.9 | 11.8 | 8.9 | 6.2 | ... |
| US | 15.0 | 13.2 | 12.7 | 12.3 | 7.8 | 5.7 |
| Group average | 11.3 | 12.4 | 14.2 | 14.9 | 13.2 | 8.5 |

Source: International Monetary Fund, *Global Financial Stability Report*, October2008
Figures for 2008 are as at March.

In part, the explanation for the strong profitability of Australian banks in recent years involves strong growth in credit. Figure 7 shows the growth of bank loans, as a ratio to GDP and by loan type: housing loans have shown the strongest trend over time, yet consumer and business loans have also seen steady growth, faster than GDP. Yet by the same token, most peer countries also saw accelerated credit growth over the period. Some might instead argue that the

impressive profit performance reflects a high degree of concentration in the local industry, yet increasingly Australian banks must compete on a global stage in a borderless world. Even taking these considerations — credit growth and market structure — into account, it is difficult to completely escape the conclusion that the performance of Australian banks reflects in-house management style, at least in part.

**Figure 7: Growth of lending by Australian banks**




Sources: Australian Prudential Regulation Authority; Australian Bureau of Statistics (ABS)

## Sound corporate governance

A recent analysis by the OECD pinpoints corporate transparency and governance as being critical to the strength and safety of financial institutions:

> In many instances of systemic instability, multiple factors have been involved and in most of them problems at financial institutions themselves have been at the core of difficulties, often related to weak management of core risks … poor governance and internal management, inadequate control of operational risks, and inadequate disclosure and lack of transparency.[8]

This has become even more important as the banking industry has grown in complexity, a fact highlighted by the current crisis. According to another official commentary, 'Traditional distinctions between different financial activities, including banking, securities dealing, and asset management, have become more blurred. As well, closer and more complex inter-linkages in the financial system have facilitated spill-over effects and implied that the systemic risk factors that (commercial) banks are exposed to are more universal.'[9]

[8] Lumpkin 2008.
[9] Schich 2008.

Against this backdrop, Australian bank boards and executives made prudent lending decisions and have minimised their exposure to toxic debt instruments. This assessment accords with the opinion of independent observers who have compared the governance of Australia's financial sector with that of other countries.

Table 10 shows Australia's rankings on two different international tests of financial-sector integrity. On both measures, Australia ranks ahead of both the US and the UK, and sits among the very best.

**Table 10: Lowest operational risk in financial sector (world rankings)**

| | Australia | US | UK |
|---|---|---|---|
| Financial institutions' transparency | 7 | 27 | 36 |
| Regulation of securities exchanges | 2 | 31 | 18 |

Sources: Transparency rankings from *World Competitiveness Yearbook 2008*, Institute for Management Development (IMD), Switzerland (55 countries rated); regulation rankings from *Global Competitiveness Report 2007–2008*, Switzerland and Harvard University (131 countries rated).
A lower ranking is more favourable.

Governance in the US banking sector appears to have played a key part in the crisis. In the years immediately prior to the crisis, the OECD argues that the US business model for banks moved too far towards an 'equity culture' with a focus on faster share price growth and earnings expansion: 'The corporate governance and risk control functions in many firms will adjust to accommodate strategy when an equity culture is mixed in with a banking credit culture.'[10]

The previous 'credit model' of banking, based on balance sheets and old-fashioned spreads on loans, was not conducive to banks becoming growth stocks. So, the strategy in US banks switched more toward fees via securitisation, which enabled banks to grow earnings while at the same time economising on capital under the Basel system.

## Effective financial system regulation

An invaluable contributor to the strength and stability of Australian banks is the quality of the prevailing regulatory framework, known as the 'twin peaks' approach. Australia adopted a functional approach to regulation recommended in the 1997 Wallis Commission report, consolidating prudential regulation from 11 predecessor agencies into the Australian Prudential Regulation Authority (APRA), and market-conduct regulation into the Australian Securities and Investments Commission (ASIC). The Reserve Bank (RBA) has oversight of financial system stability. The Council of Financial Regulators (CFR) provides a useful forum to address emerging trends and policy issues. The CFR consists of high-level representatives of the RBA, Treasury, APRA, and ASIC, and meets

[10] Blundell-Wignall *et al*. 2008.

regularly. In the event of a crisis, the CFR serves as the key coordinating body for developing an official response.

It is often observed that APRA imposes a more conservative stance on bank capital adequacy than many of its overseas regulatory counterparts. In response, APRA recently said: 'we make no apologies for this. We think that healthy capital buffers are an important source of confidence for our financial institutions.'[11] In its role, APRA conducts exhaustive surveillance. Last year, APRA carried out 624 prudential reviews of regulated financial institutions, 192 on-site risk assessments, and 3220 analyses of financial data which it requires to be submitted by regulated financial institutions. APRA's stated approach seeks to balance 'financial safety and efficiency, competition, contestability and competitive neutrality'.[12] In a recent independent evaluation the IMF said: 'Australia's approach to prudential and market conduct regulation is sound overall. There is a generally high level of compliance with international standards and in a number of areas, including transparency, Australia is at the forefront of best practices.'[13]

In addition, the IMF review remarked favourably on the question of financial-sector standards and codes of supervision: 'Australia has a high overall level of compliance with the Core Principles. The Probability Assessment and Impact Rating System (PAIRS) and Supervisory Oversight and Response Systems (SOARS) provide a foundation for banking supervision that is at the leading edge of current approaches to risk-focused supervision.'

## Separation of commercial banking from social assistance measures

In the US, a succession of government policy steps that effectively enlisted bank balance sheets for broader social objectives most likely acted as a key exacerbating factor in the years leading up to the credit crisis:

- The 1986 Tax Reform Act included the Real Estate Mortgage Investment Conduit (REMIC) rules, which can issue multiple-class pass-through securities without an entity-level tax, and greatly enhanced the attractiveness of mortgage securitisation.
- The purpose of the 1995 Community Reinvestment Act (CRA) was considered and sincerely motivated. It sought to assist low-income earners and minorities toward the goal of home ownership, and called for banks to offer more credit to at-risk small businesses. Significantly, however, this was not simply through voluntary persuasion but, rather, the CRA compelled private

11 Lewis 2008.
12 Ibid.
13 International Monetary Fund 2006.

commercial banks to devote a certain proportion of their excess reserves to such loans.

- In 2004, the Securities and Exchange Commission (SEC) allowed securities firms to raise their leverage sharply, from the traditionally accepted ratio of 12:1 to a new standard as high as 33:1, a level that encourages too-rapid balance-sheet growth and at which a mere 3 per cent decline in asset values can wipe out a firm.
- The Bush Administration's 2004 'American Dream' package of housing measures that sought to assist low-income groups through zero equity lending fuelled the flow of sub-prime mortgages.

These initiatives, well intentioned at the time, arguably had the unforeseen combined effect of forming part of a set of drivers that altered incentives and behaviour of US banking firms. They stimulated the over-production of sub-prime mortgages in the US banking system, ultimately with disastrous consequences. Coupled with other forces, such as the Federal Reserve's low-interest-rate regime, these policies caused American banks to accelerate their off-balance-sheet mortgage securitisation in order to enhance revenue streams and share price appreciation. The result was a marked acceleration in sub-prime leverage over time, beyond the normal limits of prudent balance-sheet management. According to the OECD, the 2004 'American Dream' initiative was a key factor, and a key reason why the toxic activities that led to the meltdown were so much stronger in the US than elsewhere.[14]

By contrast, Australia has generally maintained a separation between housing or social-assistance measures on the one hand, and commercial bank balance sheets on the other. This prudent approach is making a considerable contribution to the stronger and safer performance of Australian banks that we are now witnessing.

## Conclusions

The Australian banking system has withstood the worst international banking crisis in memory far more robustly than many overseas counterparts. No Australian bank has been bailed out, local banks did not create a northern hemisphere-style liquidity crunch, and Australian banks have avoided abnormal loan write-downs. No Australian bank has seen its credit rating downgraded, and share prices of our banks have been relatively strong in the circumstances.

This paper has identified a number of key factors that explain the remarkable resilience of the Australian banking sector, its strength and safety. A culture of prudent lending prevails. Australian banks are soundly capitalised, with a well-diversified and stable funding base, and a track record of healthy

[14] Blundell-Wignall *et al*. 2008.

profitability. The industry is marked by vigorous competition, as well as sound corporate governance, and robust consumer protection. Official oversight of banks is effective, involving the renowned prudential regulation system, and the separation of commercial banking from social-assistance policy.

Consequently, Australian banks have performed exceptionally well during the recent turmoil and have insulated Australia against the full impact of the credit crisis, which originated in the United States. The latest IMF commentary on Australian banking affirms this assessment:

'The securitisation of mortgages in Australia was not widespread before the crisis, with only about 18 per cent of housing loans securitised. These mitigating factors implied that Australian banks suffered only limited direct losses, compared to their counterparts in North America and Europe, and their credit ratings remained high throughout the period.[15]

Return on equity (ROE) for the Australian banks has hovered around 15–20 per cent since the mid-1990s, with the system experiencing very strong balance-sheet growth driven by high demand for residential (prime) housing loans. At the same time, because of the prudent philosophy of favouring loan origination over securitisation, the quality of Australian bank assets is high, with non-performing assets equivalent to less than 1 per cent of on-balance-sheet assets. Just the same, Australian banks have maintained a comfortable level of provisioning. Recent events have shown the regulatory framework in Australia is successful. Unlike in the UK, Europe and the US, no taxpayer's money has been allocated to support a private Australian bank.

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