December 2011

Banking in Australia 2011 – A year in review

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Whilst 2012 will start with a set of major concerns, uncertainty and challenges due to the impact of the financial crisis centered in Europe on global markets, it may be of value to give reflection on the highlights of banking and financial markets in Australia from this year looking at major banks performance, the economy and some other important developments.

Major Bank's Performance and Profits

The Australian banking industry as represented through the four major banks ANZ, Commonwealth Bank, National Bank and Westpac that dominate the market in retail, commercial and corporate banking, have had another remarkable year in terms of performance and profitability given the difficult conditions in global financial markets.

Their statutory profit 'before tax' of AUD 31.9 billion for 2011 was up 12% from their results in 2010 and this continues their historic profit/revenue growth for more than ten years.

2011 Results

	Profit Before Tax $ Billion	Profit After Tax $ Billion
ANZ	7.672	5.355
CBA	9.057	6.394
National	6.728	5.219
Westpac	8.514	6.991

Last Ten Years

Year	Profit Before Tax $ Billion	Year	Profit Before Tax $ Billion
2011	31.9	2006	22.9
2010	28.5	2005	20.0
2009	22.5	2004	16.1
2008	22.6	2003	14.8
2007	25.4	2002	13.8

Source KPMG

The 2011 results were assisted by lower impairment charges as asset quality of loans improved, net interest growth assisted by repricing of retail and commercial banking portfolios, improvement in the performance of their New Zealand operations and efficient cost containment with the average cost to income ratio moving to 45%.

Return on equity averaged 16.7% up from 15.9% in 2010 and return on assets of around 1%. The average Tier 1 capital ratio increased from 9.31% in 2010 to 10.09% in 2011 in response to further regulatory pressures.

Generally speaking, the Australian banking industry has continued to show that it is in a very robust and strong position compared with many other developed markets. It is well placed to face the further challenges from the current global financial crisis having strengthened its position in a number of respects. In particular by generating some of the best profitability of banks in the world, increasing its liquidity buffers and improving its capital position.

Australian Economy

The comparably strong Australian economy has helped to continue create relatively stable business and albeit weaker credit conditions for banks to operate in.

Australia has relatively low inflation currently at around 3.5%, an unemployment rate of 5.3% and comparatively low debt to GDP ratio. Unlike many other developed countries, there has been no suggestion that Australia's AAA rating is under review or threatened in any way. In fact, Australian bond yields have fallen to an historic low in response to further warnings of credit downgrades in the euro zone as investors seek the safety of Australia's credit rating plus its sound fiscal position. Not only is this highly prized by international investors, but Australia's comparatively high interest rate environment makes the bonds doubly attractive. In addition, company profits in general have remained strong and commodity prices have been holding up which has flowed through to mining companies generating higher profits.

Very latest economic data is showing that the mining industry is powering the economy and driving growth well above expectations. This is assisting to shield the economy from the more severe effects of the current global financial crisis. The economy grew by 1% in the September quarter for an annual rate of 2.5% and in which a number of billion dollar mining and energy works were approved. Some analysts are now predicting a growth rate of 3.5% in 2012.

Notwithstanding this, other parts of the economy are being affected by global events and this has resulted in some larger than expected reductions in government revenues and a bigger forecast budget deficit for 2011-12 although this is predicted to return to a small surplus of in 2012-13.

In addition, this has impacted the share market, on trade outside the mining sector, the retail sector in particular and on confidence, with consumers becoming more cautious and businesses more reluctant to expand their workforce in the current uncertain global environment.

As the Reserve Bank of Australia (central bank) has noted there has been in recent years a structural change in household spending and financing in Australia. After a 10–15 year period during which households increased their gearing and reduced their rate of saving, they have returned to a more conservative, and traditional pattern of financial behaviour.

- Household credit growth has slowed to a rate in keeping with, or slightly below, the growth in household incomes;
- Saving rate has increased to a level that is more normal based on history; and
- Household spending growth has slowed from a rate that substantially exceeded household income growth, to one that, over the past year, has been broadly in line with income growth.

Importance of China

The importance of China to the health of Australia's economy should not be underestimated. China has become Australia's largest export market with billions of dollars in revenue generated and with the resources sector continuing to underpin it in areas such as coal, iron ore and major LNG contracts in place for the supply of Australian gas to Chinese terminals.

On the other side of the coin, according to a most recent report (November 2011) by KPMG and The University of Sydney, Australia has become the biggest single destination for Chinese outbound direct investment over the past six years and which is estimated close to US $40 billion. These investments have been completed not only in the resources sector but in publishing and media, real estate, pharmaceuticals, logistic equipment and services, agriculture and hotels/casinos. Sectors such as manufacturing, finance, business services, construction, transport and warehousing, wholesale and retailing and scientific research have also been recipients of Chinese investment. The future potential of Chinese investment to spread its capital support of these and other businesses in Australia looks very promising.

Basel III

The Australian Prudential Regulatory Authority (APRA), the body which is responsible for prudential supervision of banks in Australia, proposes to adopt the Basel III regulatory adjustments to capital that are specified as minimum requirements, with only minor exceptions.

APRA has also been actively involved in developing the global liquidity reforms as part of Basel III and fully supports their implementation in Australia.

It will apply the new global liquidity standards to the major banks including the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR).

The LCR requires banks to hold enough cash or similar liquid security to meet requirements over a 30-day period of acute stress.

As part of these liquidity requirements, the Reserve Bank of Australia will provide a committed liquidity facility as part of Australia's implementation of the reforms.

The facility, which is required because of the limited amount of government debt in Australia, is designed to ensure that banks have enough access to liquidity to respond to an acute stress scenario, as specified under the liquidity standard.

The NSFR measures the amount of longer-term, stable sources of funding employed by an institution relative to the liquidity profiles of the assets funded and the potential for contingent calls on funding liquidity arising from off-balance sheet commitments and obligations.

The standard requires a minimum amount of funding that is expected to be stable over a one year time horizon based on liquidity risk factors assigned to assets and off-balance sheet liquidity exposures.

In terms of implementation, major Australian banks will be required to meet the revised Basel III minimum capital ratios and regulatory adjustments in full from 1 January 2013. Other requirements, including liquidity standards, will be more in line with standard Basel III timetable guidelines.

The accelerated timetable is very much in keeping with APRA's more aggressive approach to prudential supervision of banks in Australia. It was one of the first banking supervisors to implement Basel II on an accelerated timetable ahead of many other countries. Banks have however criticized the accelerated timing arguing they will significantly increase costs but this has been rejected by APRA.

Australian Bank's Funding Challenges

Australian banks have historically been reliant on offshore international markets for at least half their funding needs. Since the global financial crisis began however, and particularly over the last two years, there has been a significant shift in attracting more deposits from customers to over come some of this imbalance. More recently, deposit growth has outstripped credit growth indicating that Australian credit markets have weakened with less demand in particular for mortgage loans and that banks continue to attract more deposits through aggressive pricing and competition.

Overall, these developments have meant that major Australian banks on average now need to fund approximately 40% of their needs from sources other than deposits which includes a substantial portion of that being raised in major wholesale offshore markets. This still leaves the major Australian banks needing to raise billions of dollars in those markets and highly vulnerable to global market risk in terms of investor appetite and price.

Covered Bonds

As part of the current government's banking reforms it announced in late 2010, covered bonds are now permitted for the first time in Australia with relevant legislation passing earlier in the year. Last month, two of the major banks ANZ and Westpac made inaugural covered bond issues in the US markets. NAB has also just completed a small private placement issue this month.

Covered bonds are secured by a pool of high-quality assets on the issuing financial institution's balance sheet usually with a AAA rating. The main feature of covered bonds is that if the issuer can no longer service the periodic bond payments, investors have a preferential claim on this pool of assets and the associated cash flows. If the cover assets are not sufficient to meet the bond payments in full, covered bondholders also have an unsecured claim on the issuer to recover any shortfall. In that case, they would stand on an equal footing with the issuer's other unsecured creditors. This is known as dual recourse.

Covered bonds, although very common in many other developed markets, were resisted by the regulator APRA for many years given that they give a priority over ordinary depositors.

The current government however, under pressure from banks given their funding challenges, finally agreed to allow all banks, credit unions and building societies to issue covered bonds. This was on the basis that it would broaden access to cheaper, more stable and longer-term funding, and harness national superannuation savings to domestically fund more productive investment in the economy.

The Reserve Bank has however made it clear that banks cannot rely solely on secured issuance, such as covered bonds, to meet funding needs. This is reinforced by a restriction on the combined value of assets in covered pools securing covered bonds issued by a bank to 8% of the bank's assets in Australia. It does however point out that one of the main benefits of covered bonds will be to broaden the type of investor who buys bank bonds.

Credit Ratings Downgrade

Earlier this month, Standard and Poors announced that major Australian banks would be downgraded from their unique AA status to AA- minus. This was part of S&P's global overhaul in how it determines credit ratings for banks and after it had cut a number of credit ratings for other major international banks. The main reason it reduced the majors ratings was primarily on the basis of Australia's large external borrowings and the major bank's reliance on offshore financing.

The biggest concern of the ratings readjustment is that it may add further pressure on their funding costs which have already been impacted by the crisis in the Euro markets. However, the downgrade needs to be kept in the context of many other large international bank downgrades by S&P and its acknowledgement that Australia's banks benefit from a high degree of government and regulatory support.

European Banks Selling Australian Assets

A number of European banks facing growing domestic funding pressures have placed significant portions of their Australian loan books up for sale, raising the prospect of reduced credit supplies and higher borrowing costs. Some of the loans involve large infrastructure projects. In addition, it appears that a number of international banks may be cutting back on new lending deals as well.

European banks have dominated the syndicated loan market in the region prior to the global financial crisis, accounting for more than 35 per cent of loans in 2007, but this year a rise in US funding costs has resulted in a steep drop, with European banks accounting for only 16 per cent of loans this year, according to Australia's Financial Review.

This raises a number of issues as to the future availability of funding for these types of large projects and other forms of corporate lending. Fortuntately, it appears that a number of major Asian banks are already increasingly filling the void and being attracted to a number of larger financing deals.

Challenges and Opportunities in 2012

As already indicated, one of the critical challenges that major Australian banks will face in 2012 is their need to raise significant funding in wholesale international markets. They are however reported to be already working on contingency plans which involve measures to update internal risk models, increase liquid-asset levels and reestablish pirvate funding placement channels with investors in Japan and throughout Asia to diversify away from Europe.

On the other hand, there may be significant business opportunities for some of the major Australian banks. In particular, it is likely they will be able to bid on a range of discounted assets and other businesses in Asia and elsewhere as banks from Europe are forced to sell very good assets and profitable businesses. These are yet further growth opportunities that banks in Australia, having already gained a number over the last three years, would not have otherwise had except as a result of the continuing global financial crisis.

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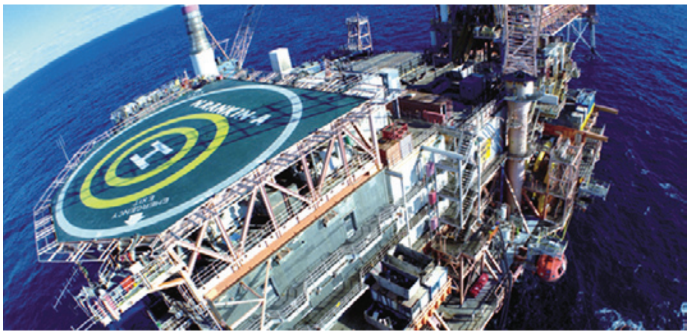

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