INTERNATIONAL LINKAGES OF THE AUSTRALIAN BANKING SYSTEM: Implications for financial stability

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This paper outlines the channels through which the Australian banking system is directly linked to international markets and the attendant financial stability implications. First, the large Australian-owned banks maintain a significant amount of international assets, including a large exposure to New Zealand and exposures within the Asian region that have grown rapidly over recent years. Second, Australian banks fund a portion of their domestic activities offshore, although post-crisis balance sheet adjustments should enhance banks’ resilience to potential future global funding market disruptions. Third, despite their small share of the commercial banking market, foreign banks operating in Australia can still influence financial stability. An earlier version of this paper was presented at the 20th Melbourne Money and Finance Conference.

Banks’ international business arises from the cross-border transactions of their home-country operations and the activities of their foreign-located operations. At a broad level, international banking may be beneficial for global economic growth through a number of mechanisms, including by facilitating trade, allocating savings to investment opportunities across economies, and increasing banking sector competition and efficiency in host countries. International banking may also help diversify country-specific risk and thus be a source of risk-sharing among banking systems (IMF 2007). However, history has shown that international banking activity can be a conduit through which financial stress is transmitted between countries ( Peek and Rosengren 2000; Gianetti and Laeven 2012).

From a regulatory perspective, problems with internationally active banks are more difficult for individual countries to resolve and global efforts to improve cross-border resolution have proved challenging (IMF 2014). In light of these global issues, this paper focuses on the nature of the Australian banking system’s links to international markets and their implications for financial stability in Australia.
Australian-owned banks’ international exposures

The large Australian banks conduct a significant amount of their business internationally. Australian-owned banks’ aggregate international exposures were about one-quarter of their global consolidated assets as at March 2015, and were equivalent to around five times their Tier 1 capital (Table 1). These ratios were slightly higher than those of a decade earlier.

<table>
<thead>
<tr>
<th>TABLE 1: Australian-owned banks’ international exposures</th>
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<tbody>
<tr>
<td>Immediate risk basis, March</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Value ($ billion)</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Growth — five-year annual average (per cent)</td>
</tr>
<tr>
<td>Share of total consolidated assets (per cent)</td>
</tr>
<tr>
<td>Ratio to Tier 1 capital (times)</td>
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</table>

Sources: APRA; RBA.

The large Australian banks are often considered to be fairly domestic in their focus. International banking data indicate that, relative to domestic credit, Australian-owned banks’ international exposure is not particularly large by international standards; in particular it is well below a number of banking systems in Europe (Figure 1). Also relevant is that none of the internationally active Australian banks has been classified as a global systemically important bank (G-SIB). G-SIBs generally have a much larger international footprint than the Australian banks — for example, as at 2014, JP Morgan alone had international assets of US$673 billion, compared with US$752 billion of total international exposures for all Australian-owned banks.

FIGURE 1: Selected banking systems’ international exposures

A feature of Australian-owned banks’ international business is that their exposure is more geographically concentrated. Three countries account for more than 70 per cent of their international exposure, whereas other large banking systems are typically much less focused on a small number of core markets (Figure 2).

Sources: BIS; IMF; RBA.
As is well known, the largest share of Australian-owned banks’ international exposures is to New Zealand (NZ), because all four major banks have substantial operations there (Figure 3). The major banks’ NZ subsidiaries are similar to their Australian commercial banking operations: they focus largely on (private sector) lending to households and businesses although, within this, lending to agriculture has a relatively high share because of the importance of the dairy industry in NZ.

Australian-owned banks also have significant exposures to the major markets of the United Kingdom (UK) and the United States (US). Among the four major banks, NAB has had the largest presence in both of these countries, mainly reflecting its commercial banking subsidiaries Clydesdale Bank and Great Western Bank. These operations have posted weaker returns than NAB Group over recent years. Most of the large Australian banks also have branch operations in both the UK and the US; these operations engage in intragroup funding, wholesale lending and financial market activities.

Sources: BIS; RBA.
Exposures to Asia represent about one-fifth of Australian-owned banks’ international exposures. Australian-owned banks have recorded strong growth in their exposures to a range of Asian countries over recent years, although the bulk of their exposures in the region are to the financial centres of Singapore and Hong Kong, as well as the two largest economies, China and Japan (Figure 4).

**FIGURE 4: Australian-owned banks’ exposure to Asia**

![Graph showing Australian-owned banks' exposure to Asia](image)

Sources: APRA; RBA.

A key motivation for expansion into Asia has been to benefit from the growing trade and investment flows between Australia and Asia (RBA 2013). Accordingly, the major banks have been providing cross-border banking services (such as trade finance and foreign exchange) to Australian companies doing business in Asia, as well as to Asian companies with activity in Australia. Some of them are also targeting intra-Asian trade flows, or expanding into retail banking in certain jurisdictions (generally with a focus on more affluent customers or those with links to Australia). While all of the major banks have increased their activity in the Asian region over recent years, ANZ has accounted for a large part of the growth. Its overall exposure to Asia is also much bigger, including its local presence in terms of the size and number of foreign offices.

**Financial stability implications**

International expansion has the potential to increase and diversify a bank’s earnings, and thus benefit its overall business. However, historical experience suggests that operating under different market, legal and cultural circumstances can entail higher levels of financial risk, such as credit risk and market risk. In particular, operational risk may be heightened given that international expansion increases the complexity of a bank’s operations; there is also a tendency for a bank’s foreign offices to not receive risk management oversight comparable with that of the head office (APRA 2013). If financial risks were to significantly materialise in a bank’s international business they could weaken the parent bank, and therefore generate risk in the home market. Intuition would suggest that the chance of this occurring increases with the size and unfamiliarity of international exposures, as well as the strength of the interconnections between the parent and its foreign offices (RBA 2014).

Australian banks have had a mixed experience with international expansion over the past couple of decades. Consistent with the view that international expansion can pose higher risks, there have been numerous cases of disproportionate credit or operational losses in their international exposures, mainly to counterparties in the UK or US. Banks’ activities or products in these markets have often differed from those in Australia, adding to the complexity of their overall business.
Unlike some of the forays into the northern hemisphere, the major Australian banks’ NZ operations have tended to perform relatively well (Figure 5). Two contributing factors are the Australian banks’ longstanding presence in NZ and the similarity of the NZ operations to their Australian businesses. At the same time, the major banks derive a relatively small diversification benefit from these operations due to the positively correlated performance of the Australian and NZ economies.

FIGURE 5: Major banks’ return on assets*

<table>
<thead>
<tr>
<th></th>
<th>2000–07</th>
<th>2008–14</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Australia**</td>
<td>0.3</td>
<td>0.3</td>
</tr>
<tr>
<td>New Zealand</td>
<td>0.6</td>
<td>0.6</td>
</tr>
<tr>
<td>Other</td>
<td>0.9</td>
<td>1.2</td>
</tr>
</tbody>
</table>

* Cash earnings is used where net profit is unavailable; financial years are end-June for CBA and end-September for ANZ, NAB and WBC.
** Based on reported geographic and business segment classifications, which vary by bank and across time.
*** Where possible Australia excludes institutional banking.

Sources: Banks’ annual reports; RBA.

Regardless of past performance, the major banks’ ongoing significant aggregate exposure to NZ represents a risk concentration from the perspective of Australian financial stability. As a practical example of how strong banking connections with NZ could affect Australia, the major banks significantly increased funding of their NZ subsidiaries during the global financial crisis prior to the announcement of government guarantees in both countries. Of course, the Australian major banks are also important for financial stability in NZ, so banking supervisors engage through activities such as stress testing and supervisory colleges, and regulatory authorities meet regularly through the Trans-Tasman Council on Banking Supervision.

The impact on the Australian economy of the major banks’ expansion into Asia is not yet clear. If this expansion were to increase and diversify the banks’ earnings over the long term, or more generally facilitate greater trade and investment between Australia and Asia, then it could prove beneficial. From a risk management perspective, the majority of exposures are shorter term and trade-related (Figure 6); these exposures typically pose lower funding and credit risks than long-term lending. However, operational and legal risks could be relatively high, including in ‘offshored’ support functions or businesses where the bank does not have full managerial control. Moreover, disruptions in Asia, principally China, would be expected to impart significant indirect effects to the Australian banking system (through macroeconomic and global wholesale funding market channels) at the same time as any direct financial risks are realised.
**FIGURE 6: Australian-owned banks’ exposure to Asia***

Immediate risk basis, March

$ billion

<table>
<thead>
<tr>
<th>Year</th>
<th>0-3 months</th>
<th>3-12 months</th>
<th>12+ months</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>0</td>
<td>50</td>
<td>50</td>
<td>100</td>
</tr>
<tr>
<td>2015</td>
<td>200</td>
<td>150</td>
<td>50</td>
<td>400</td>
</tr>
</tbody>
</table>

* Data by maturity are available for cross-border exposures and local exposures in foreign currency; they are not available for local exposures in local currency.

**Sources:** APRA; RBA.

**Australian-owned banks’ offshore funding**

Australian-owned banks use offshore credit markets to fund a portion of their domestic activities. Offshore funding currently accounts for around one-fifth of their total funding liabilities in Australia (Figure 7). A substantial portion of this is long-term funding, usually in the form of debt securities. Another aspect of Australian banks’ offshore funding is that it is mostly denominated in foreign currency, typically US dollars although, as described below, it is mostly swapped into domestic currency. The vast majority of offshore liabilities are to financial centres in the US and UK.

**FIGURE 7: Australian-owned banks’ international liabilities***

As a share of total funding liabilities in Australia, March

**By type**

- Debt issued
- Deposits

**By currency**

- USD
- EUR
- AUD
- JPY
- GBP
- Other

* Excludes derivatives and working capital.

**Sources:** APRA; RBA.
Financial stability implications

Australian banks’ use of offshore funding is regarded in some quarters as a potential source of financial instability. Certainly, periodic bouts of volatility in global credit markets over recent years have created wholesale funding pressures for Australian banks. Moreover, there is a widely held assumption that offshore creditors are more likely to withdraw their funds in times of stress than domestic creditors. This could perhaps stem from the greater substitutes for global investors’ funds, offshore creditors’ risk appetite being more procyclical and/or home bias among investors in times of stress. In Australia, the stability of domestic deposits relative to offshore funding and other domestic funding is also boosted by specific depositor protection arrangements (Turner 2011).

Banks can lessen the liquidity risk arising from their (offshore) funding by ensuring that they do not have a significant portion that is maturing in the near term. Indeed, in the post-crisis period Australian banks have increased the average maturity of their short- and long-term offshore debt. They have also significantly expanded their holdings of high-quality liquid assets. These balance sheet adjustments have enhanced banks’ resilience to liquidity shocks, and APRA’s supervision should ensure further improvements to their liquidity risk management and funding profiles over time. However, the possibility that offshore funding markets stay closed for a lengthy period (e.g. longer than one month) in the future cannot be ruled out. To help ensure such an event does not significantly disrupt economic activity, a central bank like the Reserve Bank of Australia (RBA) may, consistent with its mandate, respond by liquefying a bank’s assets (provided the bank’s assets exceed its liabilities and the collateral securing liquidity is subject to appropriate haircuts). In this way a central bank can provide society with a low-cost form of insurance against (externally generated) liquidity shocks (Lowe 2015). The RBA’s Committed Liquidity Facility pre-specifies the amount of Australian dollar liquidity that can be provided to Australian banks subject to the full Liquidity Coverage Ratio requirement.

Banks in Australia manage foreign currency risk on their offshore funding by hedging nearly all of the debt using derivatives, typically matching the underlying cash flows (Rush et al. 2013). They are instead exposed to the risk that the counterparty to the transaction — typically a global bank — is unable to honour its obligations, requiring attainment of a replacement swap or foreign currency on the spot market at prevailing rates (IMF 2012). Collateralisation of these transactions should ensure effective management of counterparty credit risk and reduce the potential for derivative interconnections to be a channel by which offshore financial shocks are transmitted to Australia.

Foreign-owned banks’ operations in Australia

Most banking activity in Australia is undertaken by domestically-owned institutions: aggregate assets of foreign-owned banks represent only 11 per cent of banking system assets (Table 2). This share is slightly lower than a decade earlier, even though the number of foreign bank branches increased over this period.

Foreign banks’ share of business credit is higher than that for resident assets, whereas their shares of household lending and deposits are lower. These outcomes are consistent with the incumbency benefits of domestic banks in mass (retail) markets as well as the typical business model choices of foreign banks (it is natural for them to focus on servicing large business customers that also operate in their home country). The business models and penetration of foreign banks in Australia are also influenced by local prudential regulation.
TABLE 2: Foreign-owned banks operating in Australia

<table>
<thead>
<tr>
<th>Prudentially licenced and regulated sector, March</th>
<th>2005</th>
<th>2010</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>By number</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>37</td>
<td>43</td>
<td>47</td>
</tr>
<tr>
<td>- Subsidiaries</td>
<td>10</td>
<td>9</td>
<td>7</td>
</tr>
<tr>
<td>- Branches</td>
<td>27</td>
<td>34</td>
<td>40</td>
</tr>
<tr>
<td><strong>By value, share of banking system</strong>(a) (per cent)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assets</td>
<td>14½</td>
<td>14</td>
<td>10½</td>
</tr>
<tr>
<td>- Subsidiaries</td>
<td>5</td>
<td>4</td>
<td>3½</td>
</tr>
<tr>
<td>- Branches</td>
<td>9½</td>
<td>10</td>
<td>7</td>
</tr>
<tr>
<td>Household credit**(b)**</td>
<td>5</td>
<td>5</td>
<td>4½</td>
</tr>
<tr>
<td>Business credit**(b)**</td>
<td>13½</td>
<td>13½</td>
<td>16</td>
</tr>
<tr>
<td>Syndicated lending**(c)**</td>
<td>58½</td>
<td>61</td>
<td>59</td>
</tr>
<tr>
<td>Deposits**(d)**</td>
<td>9</td>
<td>6½</td>
<td>8½</td>
</tr>
</tbody>
</table>

(a) Banking system includes credit unions and building societies; data are resident domestic books basis.
(b) Credit data are non-break adjusted.
(c) Includes offshore banks, mostly loans to large non-financial corporations.
(d) Excludes certificates of deposits and intragroup deposits.

Sources: APRA; RBA.

Foreign-owned banks are more prevalent in the provision of other ‘banking services’ in Australia outside of traditional commercial banking. In particular, some global investment banks are major players in financial markets, such as markets for certain over-the-counter derivatives (including swaps), securities financing, asset custody and debt and equity underwriting. And global financial conglomerates have accounted for a significant share of credit extended by registered financial corporations (which are non-prudentially regulated entities or ‘shadow banks’), although their involvement has been wound back over recent years.

Financial stability implications

There is extensive literature on the potential benefits of foreign banks to host economies (Claessens et al. 2001; Claessens 2006). In Australia, foreign banks have been an important source of competition since banking sector deregulation in the mid-1980s, particularly in large business banking, but also in retail banking. Foreign banks have also helped deepen local financial markets and provide a range of more specialised financial market services.

Nonetheless, since the financial crisis there has been a more widespread appreciation of the financial stability risks that foreign banks pose. A key financial stability concern is that foreign banking activity can add to procyclicality; international evidence suggests that lending by non-resident banks and foreign branches expands at a relatively fast pace during buoyant conditions and contracts quickly during downturns (Hoggarth et al. 2013). A related issue is that foreign banks may be more likely to acquire marginal borrowers because of the difficulty in competing with domestic banks for established (higher quality) customers.

Aggregate lending by foreign banks in Australia has proved to be relatively procyclical over the past decade. Some European bank branches that expanded their balance sheets rapidly in the lead-up to the financial crisis subsequently pulled back (with several leaving altogether), in association with local loan quality problems and difficulties in their home jurisdictions (Figure 8). The lending behaviour of foreign branches has also influenced Australian asset prices (such as commercial property prices) over this period. It is noteworthy that a number of Asian-owned banks are currently expanding their business at a rapid pace (Debelle 2015), including their commercial property lending. It remains to be seen whether this activity will be sustained over the medium term.
Another concern is the potential for foreign banks to spread problems to the host economy from elsewhere. There were cases during the financial crisis where otherwise sound foreign-owned banking businesses operating in Australia were destabilised because of problems at a foreign parent (Laker 2010). Although problems can be transmitted through foreign subsidiaries, foreign branches are more likely to do so.9 Funding, lending and operational links with their banking group tend to be much stronger for branches because they are not legally separate from the parent banks. As a measure of the connections of foreign branches operating in Australia, four-fifths hold at least 20 per cent of their total assets as intragroup claims or fund at least 20 per cent of their assets through intragroup funds; for some, the comparable ratios are above 60 per cent.

The systemic risk posed by future external shocks being transmitted to Australia through foreign bank branches or subsidiaries is limited by their small size in Australia — the largest foreign bank accounts for only 2 per cent of domestic banking assets. However, the substantial involvement of global investment banks in certain financial markets suggests that problems elsewhere in their banking groups could have a larger adverse effect on the Australian economy. It would be hard for others to replace some of their financial market activity at short notice because it is specialised and/or complex. Another relevant consideration is that some of this business is being undertaken outside the Australian prudential regulatory perimeter. As the financial market activities of global banks in Australia are often a small part of their global operations, home-country supervision might not provide adequate oversight for the risks posed specifically in Australia.

**Conclusion**

The Australian banking system is linked to international markets through a number of channels. This activity provides benefits to the Australian economy, but also poses risks. As such, international banking linkages are the subject of ongoing monitoring by the RBA and other financial regulators. A range of policies in Australia act to mitigate risks associated with international banking. Notably, sound macroeconomic policies help to bolster the economy against international shocks. Also important is APRA’s prudential regulation and risk-focused supervision, including targeted on-site visits of Australian banks’ overseas operations and engagement with host regulators (APRA 2014). Other examples include public communication of risks and domestic crisis management arrangements, such as liquidity provision to the banking system.

Even though international banking linkages are a focus for Australian financial regulators, further consideration of these issues by the research community is welcomed.10 Future research might usefully focus on how inward transmission of shocks through Australian-located banks might arise from post-crisis changes in international markets, including the growing use of central clearing for over-the-counter derivatives, new prudential rules and instruments and altered resolution regimes.
Notes

1. The authors are from Financial Stability Department at the Reserve Bank of Australia. Views expressed in this paper are those of the authors and not necessarily those of the Reserve Bank of Australia. We thank Sharon Lai, Thomas Carr and other Reserve Bank colleagues for their comments and assistance with the preparation of this paper.

2. An international exposure is defined as an on-balance sheet cross-border claim on a non-affiliate, or an on-balance sheet claim of an affiliated foreign office. Claims can be measured on an ‘immediate risk’ basis — that is, based on the country where the immediate counterparty resides. Claims can also be measured on an ‘ultimate risk’ basis, which are immediate risk claims adjusted (via guarantees or other risk transfers) to reflect the country where the counterparty risk ultimately resides. Claims on both these measures are used throughout this section because of their differing breakdowns. There is typically only a small difference between the measures for Australian banks.

3. Since March 2015 NAB has divested Great Western Bank and it is currently in the process of divesting Clydesdale Bank.

4. This assumes some maturity transformation is undertaken. Banks could use some of their short-term offshore funding to match short-term assets. In such cases they might be willing to exit short-dated business lines if funding conditions deteriorate.

5. See RBA 2014 (p. 82) for a discussion of the mechanisms by which the Australian economy may adjust to lower demand for Australian bank paper.

6. This facility is provided for a 15 basis point fee regardless of whether it is drawn upon (RBA 2011).

7. For example, foreign branches in Australia are prohibited from receiving deposits of less than $250,000 from individuals and non-corporate institutions.

8. A notable example was internet-only retail deposits offered by some foreign bank entrants in the early 2000s (Davis 2000). Their relatively attractive rates forced other banks with physical branch networks to increase their deposit rates.

9. However, by drawing on the financial strength and funding of their parent bank, foreign branches might more easily absorb purely domestic shocks.

10. The International Banking Research Network, in which the RBA participates, is one such initiative.

References


