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Banking Industry Country Risk Assessment: Australia

Primary Credit Analyst:
Gavin J Gunning, Melbourne (61) 3-9631-2092; gavin.gunning@standardandpoors.com

Secondary Contacts:
Peter Sikora, Melbourne (61) 3-9631-2094; peter.sikora@standardandpoors.com
Nico N DeLange, Sydney (61) 2-9255-9887; nico.delange@standardandpoors.com
Sharad Jain, Melbourne (61) 3-9631-2077; sharad.jain@standardandpoors.com
Craig R Michaels, Melbourne (61) 3-9631-2082; craig.michaels@standardandpoors.com
KimEng Tan, Singapore (65) 6239-6350; kimeng.tan@standardandpoors.com

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Major Factors

Strengths:	Weaknesses:
• Australia has a diversified, high-income, flexible, and resilient economy--factors that reduce the risk of significant and sustained downturns. • The banking sector benefits from conservative regulations, a strong regulatory track record, and supportive governance framework. • The banking industry is supported by a stable industry structure, a low-risk appetite, and absence of market distortions.	• The Australian economy and banking system are exposed to risks related to high external debt and persistent current account deficits. • The banking system is materially dependent on net external borrowings, and core customer deposits are not sufficient for meeting long-term bank funding needs.

Rationale

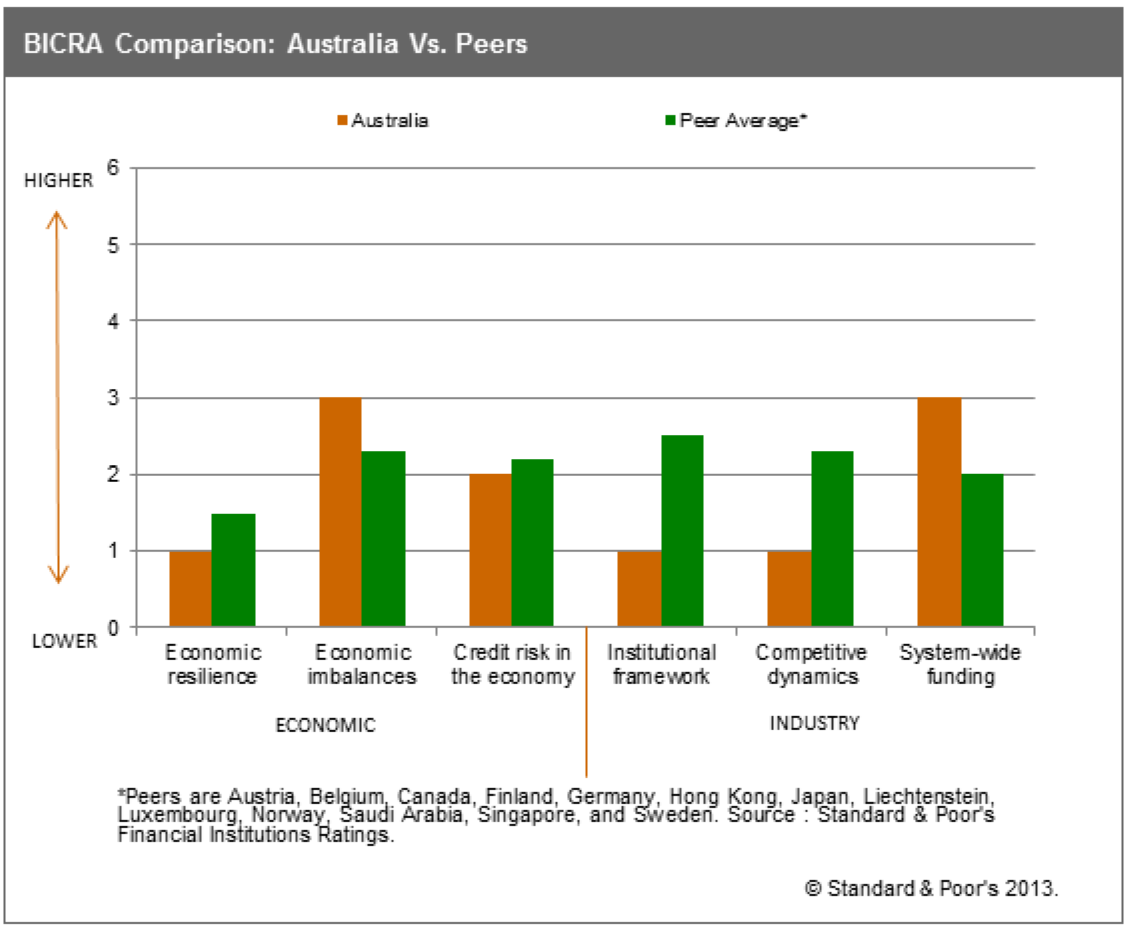
Standard & Poor's Rating Services classifies the banking sector of Australia (AAA/Stable/A-1+) in group '2' under its Banking Industry Country Risk Assessment (BICRA) criteria. There are currently 13 other countries in BICRA group '2', including Canada, Singapore, Hong Kong, Japan, Germany, and Sweden.

Our bank criteria use our BICRA economic risk and industry risk scores to determine a bank's anchor, the starting point in deciding an issuer credit rating. The anchor for a bank operating only in Australia is 'a-'.

While Australia remains a relatively low-economic-risk environment for banks by international standards, we believe that risks remain on the downside. Australia benefits from being a wealthy, open, and resilient economy that has performed well during negative cycles. We currently envisage that the economic growth, which is broadly in line with recent trends, will continue over the short-to-medium term, even considering that the commodities cycle appears to have peaked. While we are increasingly cautious about the potential risks of low interest rates contributing to higher house prices, our current base case is that likely loan losses will continue to remain low by international standards. Our concerns also remain focused on high external imbalances, including current account deficits and accompanying high external debt, that result in a material dependence on external savings to fund growth. A worsening in Australia's external position could have adverse implications for our economic risk assessment on the banking system.

Elements of Australia's industry risk environment for banks are considered low-risk. The structure of the banking industry--being dominated by a small number of strong retail and commercial banks and underpinned by a strong regulatory and governance framework--tends to be accommodative of strong bank ratings. Offsetting these positive elements, however, is that the Australian banking system features relatively low levels of core deposits and is materially dependent on net external borrowings--not surprising considering Australia's high external debt. While most banks have steadily improved their funding profiles over recent years, core customer deposits continue to be insufficient for meeting banks' long-term funding needs. We envisage little change to this scenario, over the medium-to-long term.

Chart 1



Economic And Industry Risk Trends

We continue to view the economic risk trend for Australia as it affects the banking sector as negative, although believe the risk of this trend converting into a weaker economic risk sore is no more than a one-in-three possibility over the short-to-medium term. Despite the negative trend, we believe that economic risks have ameliorated slightly, compared with 2012. We continue to have concerns about an escalation of economic risks associated with economic imbalances, given that the global economic recovery remains uncertain and the economic outlook for Australia's major trading partner China is less buoyant. That said, our current belief is that either a China soft landing (which is our 55%-65% probability base case) or medium landing (20%-25% probability) would have a "no-to-low" impact on Australian financial institutions' ratings; only a severe slowdown in China would likely have a more pronounced ratings impact. Our negative outlook also takes into account the potential risk of low interest rates re-igniting the housing market following a slight contraction of average house prices over the three years 2010 to 2012. While our base case outlook is that house price increases are likely to be digestible in the context of our current economic risk assessment and ratings, strong double digit growth into 2014 could cause us to revise our economic risk score negatively, to '3' from '2'. Conversely, should risks associated with China--and the global economy more generally--as well as the domestic property sector ameliorate, there is a possibility over the next 6-12 months of us revising the economic trend to stable from negative.

Our assessment of the system's industry risk trend is that it continues to be stable and the regulatory framework strong for the medium term. The Australian banking system has made a seamless transition to Basel III capital rules during 2013, and our stable industry assessment takes into account that the transition to Basel III funding and liquidity rules will be orderly, even if potentially more challenging than the transition to Basel III capital rules. We remain concerned that pressures on system-wide funding could re-emerge if there were a disruption in Australian banks' access to external borrowings, whether caused by euro stresses or other factors. In recent years there has been a modest strengthening of banks' funding capabilities via higher deposits, a lower dependence on external borrowings, and added diversity via inaugural covered bond issuances. However, we need further comfort that these developments are structural and permanent rather than cyclical in the recent low-growth credit environment before our concerns regarding system-wide funding would be likely to alleviate to any material extent.

ECONOMIC RISK | 2

The economic risk score for the Australian banking system is '2', based on economic resilience, economic imbalances, and credit risk in the economy; all of which our criteria defines.

Economic resilience: A wealthy, open economy resilient through negative economic cycles

Table 1

Economic Resilience						
	Fiscal year ended June 30					
	2014f	**2013e**	**2012**	**2011**	**2010**	**2009**
Nominal GDP (bil. $)	1,479	1,498	1,490	1,492	1,140	950

Table 1

Economic Resilience (cont.)						
Per capita GDP ($)	63,308	64,980	65,679	66,819	51,659	43,608
Real GDP growth (%)	3.0	2.6	3.4	2.4	2.1	1.7
Inflation Rate (CPI)	2.4	2.2	2.3	3.1	2.3	3.1
Change in general government debt as % of GDP	2.0	2.8	5.8	4.5	5.5	4.8
Net general government debt as % of GDP (%)	20.0	18.9	16.9	11.8	8.5	2.2

f--Forecast. e--Estimate. Source: Standard & Poor's.

Economic structure and stability. Our view is that Australia is a wealthy, open economy, with GDP per capita of more than US$65,000 in 2012. Australia's economic resilience reflects decades of reforms, its diverse economic structure, and flexible labor and product markets. Growth of the Australian economy is expected to slow to 2.6% in year ended June 30, 2013, from 3.4% in fiscal 2012, as mining investment peaks and begins to be a drag on growth. But we forecast growth will improve to about 3% in fiscal 2014 as other sectors gradually strengthen, supported by low interest rates. We also expect commodity exports to increase as mining projects are progressively completed and commence production. Growth in national incomes is likely to remain under pressure in the near term, despite a solid outlook for real economic growth. Australia's terms of trade are likely to continue to decline, as prices for the country's key commodity exports continue to weaken--in large part due to rising Australian and global production. Moreover, risks remain for Australia's growth prospects, prosperity, and credit quality. These stem largely from its growing dependence on trade with China. If demand for Australia's resources were to weaken sharply, this could lead to a range of disorderly dislocations in the economy, including in its labor and property markets. However, while robust demand for its commodities continues--from emerging Asia, and particularly China--we believe Australia's economic prospects over the forecast period will remain favorable.

Macroeconomic policy flexibility. We believe that the Australian government has high fiscal flexibility, underpinned by low public debt and strong fiscal discipline. We also consider the high monetary policy flexibility as being supported by the Reserve Bank of Australia's (RBA) track record of operational independence, use of market-based instruments, and clear objectives, as well as Australia's free-floating and highly traded currency. We also expect that inflation will remain within the central bank's 2%-3% annual average target range over the business cycle, and that there will continue to be stable political consensus on orthodox fiscal, monetary, and exchange-rate policies. Although Australia's public finances have worsened as a result of the global recession, the deterioration has been much more contained than for most other developed countries whose steep deficit increases have been more pronounced and will likely persist for longer. We believe that the general government will show a deficit of about 2.0% of GDP in 2014, and that its net debt burden will equate to about 20% of GDP in 2014 before trending lower as the deficit shrinks further. This level of government debt is considerably lower than that of peers.

Political risk. We believe that Australia has an effective, stable, and predictable framework of policymaking that is backed by mature political institutions. Successive governments have a strong track record of managing challenges and implementing policies that promote sustainable economic growth. After six years in opposition, the center-right Liberal-National Party coalition won the right to form government on Sept. 7, 2013, and we expect the new government to pursue a broadly similar fiscal strategy to the previous government, targeting the narrowing of budget deficits over time. In line with the coalition's pre-election announcements, we expect new spending measures to be broadly offset by savings measures, particularly cuts to the bureaucracy and unwinding of recent policies related to household payments. In our view, there are no significant or immediate external security risks, and the external organizations have minimal effect on policy setting. Also, we consider that public finance data and statistical information are comprehensive, reliable, and timely.

Economic imbalances: High external debt of primary concern; with rising house prices an emerging risk

Table 2

Economic Imbalances

	Fiscal year ended June 30					
	2014f	**2013e**	**2012**	**2011**	**2010**	**2009**
Annual change in domestic credit private sector & NFPEs as % of GDP	(0.1)	2.3	2.0	(4.9)	4.4	2.0
Annual change in residential housing prices (real): national	7.2	2.9	(4.1)	(5.8)	13.7	(3.7)
Annual change in commercial real estate price index (real) (%)	N/A	0.9	7.5	3.6	0.7	(15.3)
Annual change in equity index (inflation-adjusted) (%)	N/A	14.2	(13.4)	4.0	6.5	(27.3)
Current account balance as % of GDP	(4.3)	(3.5)	(2.7)	(2.4)	(4.4)	(3.1)
Net external debt as % of GDP	55.8	53.1	52.9	50.8	52.8	54.3

f--Forecast. e--Estimate. NFPEs: Nonfinancial public sector enterprises. N/A--Not applicable. Source: Standard & Poor's, the Australian Bureau of Statistics, and The Reserve Bank of Australia.

Expansionary phase. We believe that the Australian economy remains in an expansionary phase. While real house prices and domestic credit to private sector/GDP (see table 2) have on average been relatively flat over the past four-to-five years, we consider that expansionary-phase methodology (rather than the "correction phase" methodology) as more appropriate. This is because we believe that the risk is that these and similar metrics have the potential to increase in the short-to-medium term as the effects of low interest rates, including four official interest rate cuts during the past 12 months, are likely to have a stimulatory effect on growth prospects. We note that credit losses for the Australian banking system have been low by international standards and manageable at current rating levels. We anticipate no material change in this trend over the short-to-medium term.

Private sector credit growth. We note that there has been a moderation in the growth trend of private sector credit (and real estate prices) in recent years. We expect that the private sector credit growth will remain modest in the medium term, reflecting a generally more conservative attitude shown by the private sector in recent years (since the onset of the global financial crisis), which has manifested in deleveraging by parts of the household and corporate sectors.

Real estate prices. While average residential property prices over the past three years have been slightly negative, we believe that currently rising house prices represents an increasing risk to the banking sector. We believe that higher residential property prices leading into 2014 are likely in the current low interest environment, although for this factor by itself to cause us to revise our economic risk score to '3' from '2' residential house prices would have to increase significantly over the next year, likely accompanied by a simultaneous strong increase in the ratio of private sector credit as a percentage of GDP.

Equity prices. In our view, the trend in equity prices does not indicate any significant additional build-up of economic imbalances, noting that equity index gains over the past fiscal year largely had only a reversing effect on losses from the prior year. Furthermore, we believe that the banking sector's direct exposure to equities is minimal, although there is a degree of indirect exposure through parts of the corporate sector that are dependent on capital markets for equity funding, as well as through the fund management and insurance subsidiaries owned by the major banks.

Current account and external debt position. In our opinion, we believe that Australia's "external risk" (as defined in our sovereign criteria) causes a "significant vulnerability" with respect to economic imbalances. Australia's persistent current account deficits and high external debt burden reflect a high dependency on external savings to fund economic growth, and exposes Australia to the risk of abrupt shifts in investor sentiment, that could result in capital flight and a sharp fall in the currency. We believe that this, in turn, could undermine consumer confidence in the economy, including the property sector. External liabilities remain high, with narrow net external debt at an estimated 254% of current account receipts for fiscal 2013. Australia's gross external financing requirement (the current-account balance plus amortization of long-term external debt plus stock of short-term external debt) are also substantial, estimated to be about 263% of current-account receipts in fiscal 2013.

A tandem risk is Australia's high vulnerability to shifts in commodity income, particularly if there were to be a weakening in China, which is a major destination for Australia's commodity exports. In our opinion, the risk of a China soft landing (which is our base case, and is considered to be a 55%-65% probability) or medium landing (which we consider to be a 20%-25% probability) is likely to have a no-or-low impact on Australian bank ratings. A China hard-landing, however, could have a material negative impact on bank ratings although we only consider this scenario to be about a 5% probability. (See the 'Alternate Scenario' section of this report for more detail).

We believe that these risks are somewhat ameliorated by a large portion of external debt being denominated in Australian dollars or hedged, plus the independence of Australia's monetary policy, with an actively traded and free-floating currency that allows external imbalances to adjust.

Credit risk in the economy: Sound underwriting standards and a still-low loss outlook

Table 3

Credit Risk In The Economy

	Fiscal year ended June 30					
	2014f	**2013e**	**2012**	**2011**	**2010**	**2009**
Per capita GDP ($)	63,308	64,980	65,679	66,819	51,659	43,608
Domestic credit private sector & NFPEs as % of GDP	127.8	127.8	125.5	123.6	128.5	124.1
Household debt as % of GDP	83.7	84.3	81.9	80.7	82.1	74.9
Household net debt as % of GDP	N/A	(145.1)	(134.0)	(131.6)	(133.6)	(130.3)
Corporate debt as % of GDP	44.7	43.6	44.4	43.8	47.4	51.2
NPAs as % of System-wide loans (year-end)	1.5	1.6	1.9	2.1	2.2	2.0
FC lending (% of total lending)	N/A	5.5	4.4	4.3	5.0	3.8

f--Forecast. E--estimate. NFPEs: Nonfinancial public sector enterprises. NPAs: Nonperforming assets. N/A--Not applicable. Source: Standard & Poor's, Australian Bureau of Statistics, Australian Prudential Regulation Authority and Reserve Bank of Australia.

Private sector debt capacity and leverage. In our opinion, domestic credit to the private sector in Australia remains moderately high, despite slower growth in recent years (see table 3). We note, however, that the private sector's debt-bearing capacity is supported by high income and wealth levels--these factors ameliorate our concerns, to an extent. Financial assets held by the household sector were about 229% of GDP in 2013, compared with household debt of about 84% of GDP. We highlight however, that superannuation (retirement) account balances form a large part of the financial assets, with Australia having higher levels of retirement savings compared with many other economies – but that these funds are generally not available to assist households in periods of financial stress. Further, the corporate sector has deleveraged materially, as reflected in a significant reduction in the corporate debt-to-GDP ratio of about 44% of GDP in 2013 (compared with about 53% in 2008).

Base-Case Credit Losses

We expect that the credit losses in the next two to three years are likely to remain at about the current level (see table 4). While GDP growth has dipped slightly to about 2.6% in fiscal 2013, from 3.4% in fiscal 2012, we estimate that GDP growth over the next two fiscal years should average about 3%. Further, other key factors influencing borrower loan serviceability do not cause us a great deal of concern, in particular noting that our base case is for the economy to remain at or close to full employment over the short-to-medium term. Nonperforming loan levels and credit losses have continued to trend down during fiscal 2013 following their peak in 2010 during the global financial crisis.

In the short-term, we expect:

- Flat to slightly lower charge-off rates for most major loan categories, with system-wide charge off rates in the vicinity of 0.3%.
- Charge-off rates for prime mortgages to likely remain very low by international standards, in the region of 5 or less basis points.
- Corporate and commercial charge-off rates to edge lower but likely to stabilize at or about the 0.5% range.
- Limited short-to-medium term prospects for improvement of charge-off rates below about 1.3% for personal lending, including unsecured credit card lending.

Table 4

Actual And Projected Credit Loss Rates* (As % of Lending)

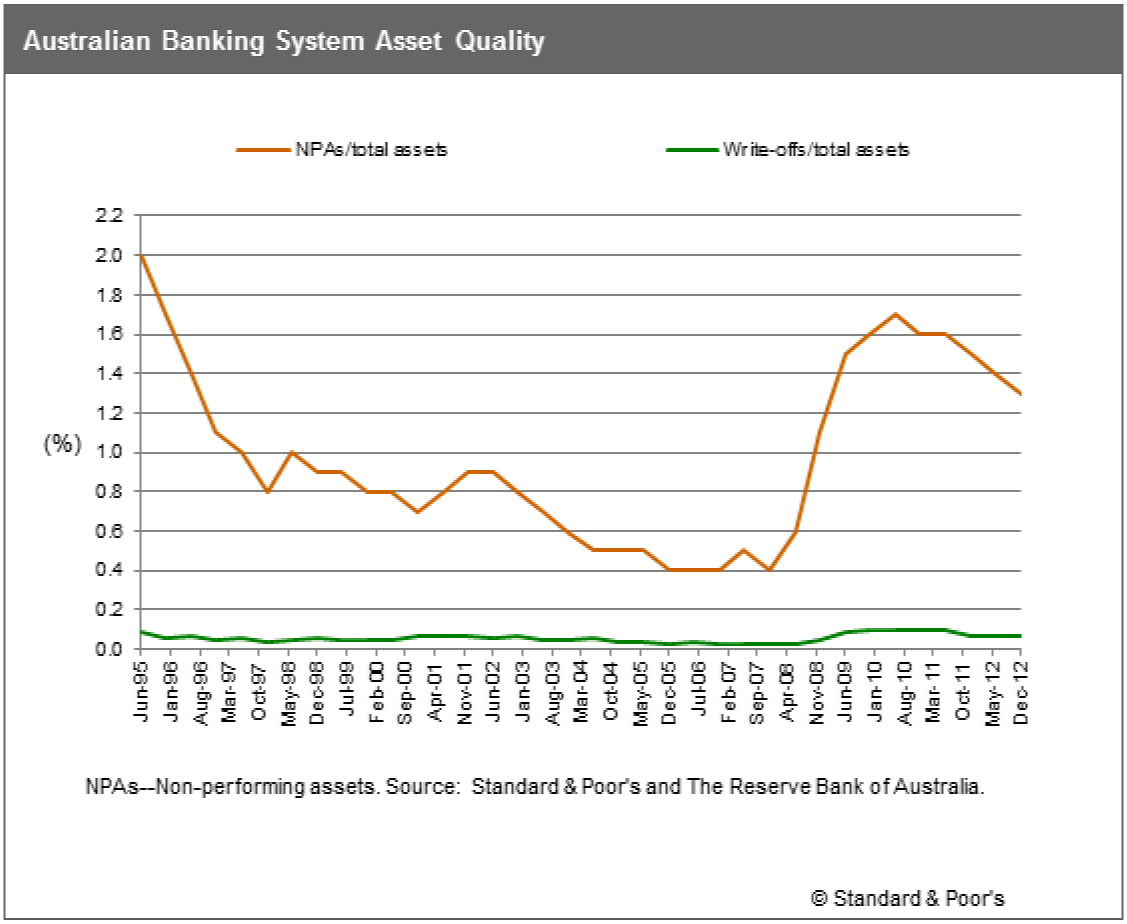
	--Year ended Sept. 30--			
	2012 (Actual)	2013 (Estimated)	2014 (Projected)	2015 (Projected)
Prime residential mortgages	0	0	0.1	0.1
Credit cards and other personal loans	1.4	1.3	1.3	1.3
Corporate	0.6	0.5	0.5	0.5
Total lending portfolio	0.3	0.3	0.3	0.3

*Credit loss rate has been calculated as write-offs divided by on-balance-sheet credit exposures. The numerator (write-offs) include credit losses incurred on loans as well as securities, where relevant. Similarly, the denominator (on-balance-sheet credit exposures) includes loans as well as securities, where relevant. Source: Standard & Poor's and bank disclosures.

Lending and underwriting standards. In our view, lending and underwriting standings in Australia are conservative. We believe that lending criteria include generally rigorous serviceability tests and security valuations, with most lending policies, including those concerning loan-to-valuation, appearing sound. Lending concentrations generally are not large--whether to higher-risk sectors, single names, or foreign currencies--and are generally well managed. The largest sector concentration is to residential property, where exposures are generally well managed and risks are considered to be relatively low by international standards. Loan write-offs associated with prime Australian residential mortgages have averaged less than five basis points per year for Australia's four major banks over the past five years. Risks associated with securitization, derivatives, and higher-risk lending activities such as property construction do not appear to be significant, and seem well managed. Australia's major and regional banks are not engaged in investment-banking activities. Exposure to interest rate risk is relatively lower than in many other systems, and interest rate re-pricing flexibility is higher, due to the preponderance of assets and liabilities written at floating rather than fixed rates.

Payment culture and rule of law. In our view, the payment culture and rule of law in Australia are strong. We consider that the legal framework is predictable and supportive of creditor rights, in that creditors generally are able to recover collateral without inordinate delays in the event of foreclosures. We note that Australia scores strongly on the World Bank's Rule of Law and Control of Corruption indicators (+1.78 and +2.16, respectively).

Chart 2



INDUSTRY RISK | 2

We base our industry risk score for Australia on our assessment of institutional framework, competitive dynamics, and system-wide funding.

Institutional framework: Strong banking regulations and supervision a key strength of the system

Banking regulation and supervision. We believe that banking regulation and supervision in Australia are strong. We consider regulations as being more conservative than the international standards, and regulatory coverage and reach as being extensive. There is one central regulator--the Australian Prudential Regulation Authority (APRA)--which supervises all deposit-taking institutions, insurance companies, and superannuation funds in Australia. We observe that APRA monitors the banks closely and frequently. APRA works in close cooperation with the central bank--the RBA--and the corporate sector regulator, the Australian Securities and Investments Commission (ASIC), when needed.

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In comparison with international peers, APRA applies more stringent deductions when computing qualifying regulatory Tier 1 capital and significantly higher loss-given-default floors on residential mortgages, and requires banks to hold capital for interest rate risk in the banking book. We also note that APRA's loss assumptions for residential mortgages are more conservative than for Standard & Poor's risk-adjusted capital framework.

Regulatory track record. In our opinion, APRA has shown a strong regulatory track record for the banking sector, including a track record of early action and prevention of any significant adverse issues even if it could hardly be said that Australia was at the epicenter of the global financial crisis. Nonetheless, we believe that this, in part, is evidenced by the absence of serious financial distress and any need for authorities to inject capital to support banks over the past several years. APRA proactively increased risk weights for riskier lending (including low-documentation residential mortgages) in 2004, and intensified monitoring of banks' liquidity and funding during the global financial crisis. APRA is typically an early adopter of more stringent regulations. For example, its timetable for implementation of Basel III capital standards was much more accelerated compared with many other countries; it also opted for a full rather than staged implementation timetable.

Governance and transparency. We consider that governance and transparency in the Australian banking industry is adequate. The larger banks are listed on the local stock exchange (the Australian Stock Exchange, or "ASX"), and are subject to strict continuous disclosure requirements. Banks provide timely release of full-year accounts prepared and audited under IFRS standards. Additionally, they release detailed six-monthly accounts, trading updates, and quarterly pillar-3 disclosures. Material accounting restatements are rare.

Competitive dynamics: A stable industry dominated by four strong banks

Table 5

Competitive Dynamics

	Fiscal year ended June 30					
	2014F	**2013**	**2012**	**2011**	**2010**	**2009**
ROE of domestic banks (%)	14.0	13.8	13.7	14.0	13.1	9.9
ROE of corporate sector (%)	N/A	N/A	17.6	19.8	13.7	20.4
System-wide return on average assets for banking sector (%)	0.9	0.9	0.8	0.8	0.6	0.5
Net interest income to average earning assets for banking sector (%)	1.9	1.9	2.0	2.1	2.2	2.2
Market share of largest three banks	63.0	62.7	60.7	60.0	63.7	63.8
Market share of gov't-owned + not-for-profit banks	1.7	1.7	1.6	2.0	1.9	1.8
Market share of non banks in total systemwide assets (%)	1.7	1.7	1.6	2.0	1.9	1.8

f--Forecast. N/A--Not applicable. Source: Standard & Poor's, Reserve Bank of Australia, Australian Prudential Regulation Authority, Australian Stock Exchange.

Risk appetite. We consider that the Australian banking industry benefits from an overall low-risk appetite, reflected in a prolonged trend of reasonably stable earnings metrics compared with other sectors. Banks generally have a track record of prudent risk pricing and management rather than chasing aggressive growth or returns (see table 5). Our assessment takes into account relatively low use of innovative, complex, and risky products, and limited high-risk lending.

We note that while residential mortgages form a significant portion of lending by the banking sector, use of subprime mortgages has been minimal. We believe that use of securitization and covered bonds is limited to vanilla products, and is aimed at diversifying funding risks rather than shifting them. We believe that banks do not engage in significant proprietary trading, and that offshore activities are generally not in significantly riskier geographies. Furthermore, foreign currency lending forms only a small percentage of total lending, with currency risks typically hedged.

Industry stability. In our opinion, Australia's banking industry is stable. We believe that the risk of a significant change in the competitive landscape is minimized by an oligopolistic banking system that is dominated by four major banks that have stable market shares. We believe that the probability of material new entrants is low. We do not consider there being overcapacity in the banking system, noting that the banks have historically been able to generate satisfactory risk-adjusted returns without taking undue risks.

Market distortions. In our view, the Australian banking industry is characterized by an overall absence of market distortions. The government does not influence the competitive dynamics by measures such as directed lending or ownership of banks. Furthermore, the nonbank competitors are mainly building societies and credit unions (which collectively account for less than 2% of total banking system assets), which are typically mutual organizations. In our view, they show generally conservative growth and earning appetites, and stick to their niches.

System-wide funding: Reliance on non-deposit sources of funding heightens concerns

Table 6

System-Wide Funding

	Fiscal year ended June 30					
	2014f	**2013e**	**2012**	**2011**	**2010**	**2009**
System-wide domestic core customer deposits*/system-wide domestic loans§	42.4	41.9	40.5	39.7	38.5	39.0
Banking sector net external debt/system-wide domestic loans	13.2	14.8	16.7	19.7	23.6	26.9
System-wide domestic loans/consolidated system-wide assets¶	71.0	71.0	71.6	71.6	70.9	65.7
Outstanding bonds and CPs issued by the private sector in the domestic markets/GDP (%)	47.4	50.1	52.7	55.3	60.1	63.4

f--Forecast. e--estimate. *Core customer deposits have been calculated as 100% of deposits from households plus 50% of deposits from nonfinancial enterprises (excludes deposits from financial institutions, or from offshore entities. Enterprises excludes loans to governments and financial institutions, or to offshore entities). §Systemwide domestic loans include domestic loans extended by the banking sector to households and nonfinancial domestic subsidiaries. ¶Consolidated systemwide assets include consolidated assets for domestic operations including consolidated domestic subsidiaries.

Core customer deposits. In our view, the Australian banking system receives a limited support from core customer deposits, which fund only about 42% of domestic customer loans despite an improving trend in the recent years. Nevertheless, we believe that confidence in bank deposits is high, reflected in the absence of a major run on bank deposits for more than two decades, noting that fleet-footed actions of the government in guaranteeing bank deposits following the onset of the global financial crisis minimized the possibility of this occurring at that time. Deposits are also supported by a healthy domestic savings rate of about 25% of GDP, although a large part of household savings are through contributions to the superannuation funds.

External funding. In our opinion, the system-wide funding of Australia's banking industry is weakened by a material dependence on net external borrowings. These borrowings currently fund about 14% of domestic customer loans, although there has been a trend of reducing dependence in the recent years. Our opinion is that cross-border funding is a more vulnerable source of funding for a banking system during periods of economic, financial, or liquidity distress, noting equally that domestic Australian investment management and other institutions investing offshore are also more likely to return to Australia during times of stress, and that these funds are likely to be held by the domestic banks. This experience was, to a large extent, what occurred recently, during the global financial crisis.

In particular, we hold the view that the Australian banking system's potential sensitivity to a disruption in external funding could be more pronounced during a period falling property prices, or increased credit losses. Nevertheless, we believe that the major Australian banks have developed good franchises in the global wholesale funding markets across a number of geographies and types of investors,--which we believe would assist them to manage these risks. Australian bank funding capabilities have stepped up in the past 18 months as the Australian major banks transacted their inaugural offshore covered bonds. These issues have been very popular with offshore investors, whom seem attracted by the very high quality of the underlying securities backing the deals.

Domestic debt capital markets. We are of the opinion that the Australian banking system benefits from access to a broad and deep debt capital market. We believe that funding sourced from domestic-debt capital markets is relatively more stable than that sourced externally, although it is less stable than core customer deposits. In our view, the outstanding short- and-medium-term debt issued by the Australian private sector within the domestic capital markets is sizeable. Although the market is limited for noninvestment-grade debt, we note that all the Australian banks are rated in the investment-grade range.

Government role. In our opinion, the Australian government and central bank play strong roles in supporting the funding needs of Australia's banks. In our view, the government and the RBA are responsive and flexible to banks' funding needs. The government has an effective track record of providing guarantees for wholesale and retail funding throughout the global financial crisis. Additionally, the central bank also catered to the funding needs of the banks by modifying eligible collateral criteria.

The RBA is also in the process of setting up a committed liquidity facility for the Australian banks, as part of implementation of the Basel III liquidity reforms in Australia. This facility is scheduled to come in force from Jan. 1, 2015, concurrently with APRA's implementation of the Basel III Liquidity Coverage Ratio. This facility has been required in Australia because of the limited amount of government debt in the country. This facility should help the Australian banks access liquidity to respond to an acute stress scenario, as specified under the proposed regulatory liquidity standards. The proposed liquidity facility will enable the participating banks to access a pre-specified amount of liquidity by entering into repurchase agreements of eligible securities. Eligible securities for this facility will include securities eligible for the RBA's normal open market operations, plus certain related-party assets issued by bankruptcy-remote vehicles, such as self-securitised residential mortgage-backed securities (RMBS).

Peer BICRA scores

Summary scores for some of the Australian banking system's peers show that the component scores for Australia are broadly in line with other banking systems in BICRA group '2' (see table 7).

Table 7

Peer BICRA Scores

	Australia	Canada	Singapore	Hong Kong	Japan	Germany	Sweden
BICRA group	2	2	2	2	2	2	2
Economic Risk score	2	2	3	3	2	1	2
Industry Risk score	2	2	2	1	3	3	3
Country classification of government support	Highly Supportive	Supportive	Highly Supportive	Highly Supportive	Highly Supportive	Supportive	Supportive

Source: Standard & Poor's.

We see a number of similarities between the Australian and Canadian banking systems, with Australia and Canada being the only two banking systems globally whose institutional framework as well as competitive dynamics have been assessed as of "very low risk." The economic-risk assessment is also broadly similar between the two systems, resulting in an economic risk score of '2' for each.

Australia's economic risk score is weaker than Germany's, mainly reflecting our assessment that risk of economic imbalances in Germany is lower than that in Australia. On the other hand, we have assigned an "industry risk" score of '2' to Australia, compared with '3' for Germany and Japan, mainly reflecting our view that more favourable institutional framework and competitive dynamics are in operation in Australia.

Government support

We classify the Australian government as being "highly supportive" of the country's banking system, reflecting our expectation of the government's timely financial support to ensure the stability of the financial system, if needed. This assessment factors in a well-developed administrative and institutional framework that should facilitate a timely and coordinated response, and a track record of proactive and prompt support for the banking system through measures such as guarantees for funding during the global financial crisis at a time when bank asset quality in Australia remained in good shape by international standards. We believe that the government's existing legislation, policy, and relationships with supranational agencies do not hinder it from assisting the banking system. We classify systemic importance of the four major Australian banks as "high" (as defined in our criteria) (see table 8). These are the only four institutions of 30 we rate that are classified as being of high systemic importance.

Table 8

Five Largest Financial Institutions By Assets

	Assets (bil. US$)*	Systemic importance
Commonwealth Bank of Australia	753.3	High
Westpac Banking Corp.	707.3	High
National Australia Bank Ltd.	795.9	High
Australia and New Zealand Banking Group Ltd.	702.2	High
Macquarie Group Ltd.	157.4	Low§

*At March 31, 2013, except Commonwealth Bank of Australia, at Dec. 31, 2012. §Macquarie Group Ltd. is the non-operating holding company of the group. Macquarie Bank Ltd. (A/Stable/A-1) is the main bank operating subsidiary and is classified by S&P as of moderate systemic importance. Source: Standard & Poor's, respective company financials.

Alternative Scenarios

The BICRA scores and trend reflect our baseline view of likely economic and industry developments for Australia's banking sector. We assess two alternative scenarios to consider potential rating implications, both being more pessimistic scenarios than our base case. These are a China medium landing and China hard-landing scenario, noting that we believe that a potential China downturn would be one of the more likely scenarios that could lead to an Australian macro-economic downturn that was felt by the banking sector. (This is not to discount the possibility of other potential causes of a macro-economic downturn.) We have not assessed an alternative optimistic scenario, as it currently difficult for us to envisage a scenarios that would facilitate an upward revision of our current 'BICRA group '2' assessment for Australia to 'BICRA group 1'.

In a China medium-landing scenario, which we estimate to be a 20%-25% probability, we believe that China's GDP growth could slow to 6.8% in 2014. Likely resulting falls in commodity prices could lead to deferral of some mining investment projects, while Chinese demand for Australia's resources weakens somewhat. Coupled with likely dampened confidence in the economy more broadly, Australia's GDP growth could slow to 2.1% in 2014. We estimate that a likely concurrent but moderate rise in the employment rate could occur, weakening confidence in the housing market and leading to potentially moderate declines in real estate prices. In this scenario, we believe that the economic risk score for Australia could drop to '3' from '2', which would not cause a change in our 'BICRA group 2' assessment for Australia but could result in negative rating changes for a small minority of financial institutions--most particularly those with marginal capital at their current rating levels.

In a China hard-landing scenario, which we estimate to be a 5% probability, we estimate that China's GDP growth slows down to 5% for 2014. Likely associated sharp falls in commodity prices and the Australian dollar could result in disorderly dislocations in the Australian economy. This could cause Australia's economy to fall into recession, with an estimated GDP growth of negative 1%. This in turn could result in a material increase in the unemployment rate, and a material decline in residential property prices. Under this scenario, the BICRA could be revised negatively to 'group 3' from 'group 2', resulting in the stand-alone credit profiles of all financial institutions being negatively affected by one notch.

Related Criteria And Research

- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Sovereign Government Rating Methodology And Assumptions, June 30, 2011
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
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