NEWS

Move over capital strength, liquidity is now APRA's big bank worry

Analysis by business reporter Stephen Letts

Updated Thu 17 Sep 2015, 9:12am

So, apparently Australian banks are "well capitalised and their risk-based capital ratios are as high as they have ever been".

That comment from Australian Prudential Regulation Authority chairman Wayne Byres in a speech to the Actuaries Institute should have drawn a huge sigh of relief, and perhaps a wave of high-fives down at the Bankers' Club.

After all, Mr Byres had harped at the big four to build-up their capital buffers to be in the top quartile of global banks, thus making them "unquestionably strong" and hopefully safe in the face of a financial meltdown.

His push was in line with Financial System Inquiry chairman David Murray.

But no sooner had Mr Byres given the big banks a pat on the back for their efforts to build up capital ratios, then ...whack!

Not only was their liquidity not up to scratch, but their funding models did not pass the sniff test either.

PHOTO: Global liquidity and funding standards potentially has a greater impact on the Australian banking sector than changes to capital requirements. (AAP)

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Mr Byres was as severe as a banking regulator can be — pointed, but not so pointed as to cause wholesale anxiety among depositors and investors

Bank liquidity and funding not up to global standards

While most of the bank related hand-wringing over the past year has been about capital, Mr Byres noted global liquidity and funding standards potentially had a greater impact on the Australian banking sector than changes to capital requirements.

"The only observation that I want to make is that given their funding structures, the largest Australian banks do not easily meet the new standard and, as things stand today, international comparisons are not favourable to them," Mr Byres said.

Ouch.

Actually, Mr Byres made a fair few more observations.

His principal concerns centre on the banks' excess of loans over deposits and their reliance on foreign-sourced funding.

While the banks have actively chased deposit growth, in recent years the growth has primarily come from "at-call" rather than term deposits.

As Mr Byres dryly noted, not all deposits have similar liquidity characteristics.

"The apparent ceasefire in the war for deposits means liquidity profiles have been strengthened less than it might first appear," he said.

Translation: Banks are not as liquid as they should be.

> Banks in Australia do have a history in making some questionable decisions on the structure and direction of their liabilities
>
> Ian Rogers, Banking Day publisher

But the bigger worry for APRA was the composition of funding.

"While the industry has reduced its reliance on short-term funding, wholesale funding and offshore funding, it has not materially reduced its reliance on the form of funding that is most likely and able to run in a crisis: short-term wholesale funding from offshore," Mr Byres warned.

"That might seem paradoxical, but as a percentage of total funding, short-term wholesale offshore funding is virtually unchanged from a decade ago."

That means banks would likely be required to hold more longer-dated funding to be considered resilient.

A history of questionable funding

Publisher of the respected industry newsletter Banking Day, Ian Rogers, said it was "interesting to see Wayne Byres and APRA waving the liquidity flag".

"Banks in Australia do have a history in making some questionable decisions on the structure and direction of their liabilities," Mr Rogers said.

"As recently as the early 2000s, bank funding was vulnerable to being devastated by the kinds of shocks that turned up globally in 2007 and 2008.

"So Australian banks do not have a history of getting their funding right, giving APRA every reason to patrol their conduct."

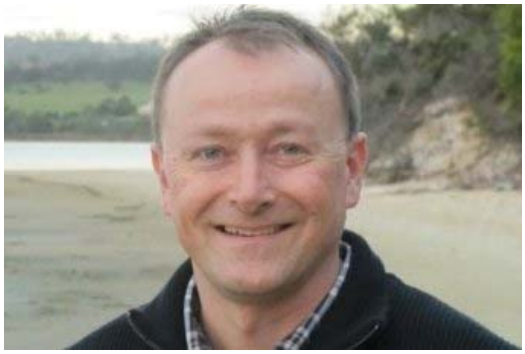

PHOTO: Banking Today publisher Ian Rogers believes the big banks have a history of 'questionable decisions'. (LinkedIn)

The slow-but-steady introduction of the global Basel III reforms has made an impact.

The revised liquidity coverage ratio (LCR) endorsed by the Basel committee in January 2013 — but only introduced earlier this year — has stopped banks holding debts of each other and calling them liquid assets.

A nice accounting trick, but if one bank got into difficulty, they all would.

Bad debt provisioning also in APRA's cross-hairs

But that's not the end of the regulatory screw-tightening.

The provisioning of problem loans is, as Mr Byres put it, "of significant regulatory interest, even if it attracts less public attention than capital and liquidity".

With top-line earnings drying up, the steady reduction of bad and doubtful debts and lowering provisioning for those loans have been a big driver in the banks' ability to keep reporting higher profits in recent years.

Research from investment bank UBS last year found the banks' earnings growth in 2013 was entirely due to cutting bad debt charges — and, to a lesser extent, a lower tax rate — and without them earnings would have shrunk by 0.2 per cent, not the 3.2 per cent increase reported.

The banks' use of the incurred loss model for provisioning may be loved by accountants and bank chief financial officers, but not so by prudential regulators.

"Incurred loss provisioning has tended to lag adversity and hence be pro-cyclical, something regulators generally try to discourage," Mr Byres said.

The impending change to an expected loss model is a more forward-looking view of things turning bad and, in APRA's view, will lead to a strengthening in provisioning levels.

Or, put another way, it is likely to lead to a fall in profitability.

Shareholder returns will fall

Mr Byres expressed a subtle message before the Actuaries Institute audience.

"By making banks more resilient and in particular less leveraged, it was envisaged that returns to shareholders — both expected and required — would fall somewhat," he said.

"The regulatory reforms did not, of themselves, set out to determine the appropriate returns to shareholders from the business of banking.

"One of the more interesting questions that I think remains open to debate is where the right RoE [return on equity] for a more resilient banking system is likely to settle."

The short answer is lower, with the glory days of the pre-Global Financial Crisis 20 per cent-plus RoEs that banks enjoyed now appearing to be well and truly over.

The price of the banks being "unquestionably strong" not just in capital, but also in liquidity and asset quality, will not be cheap.

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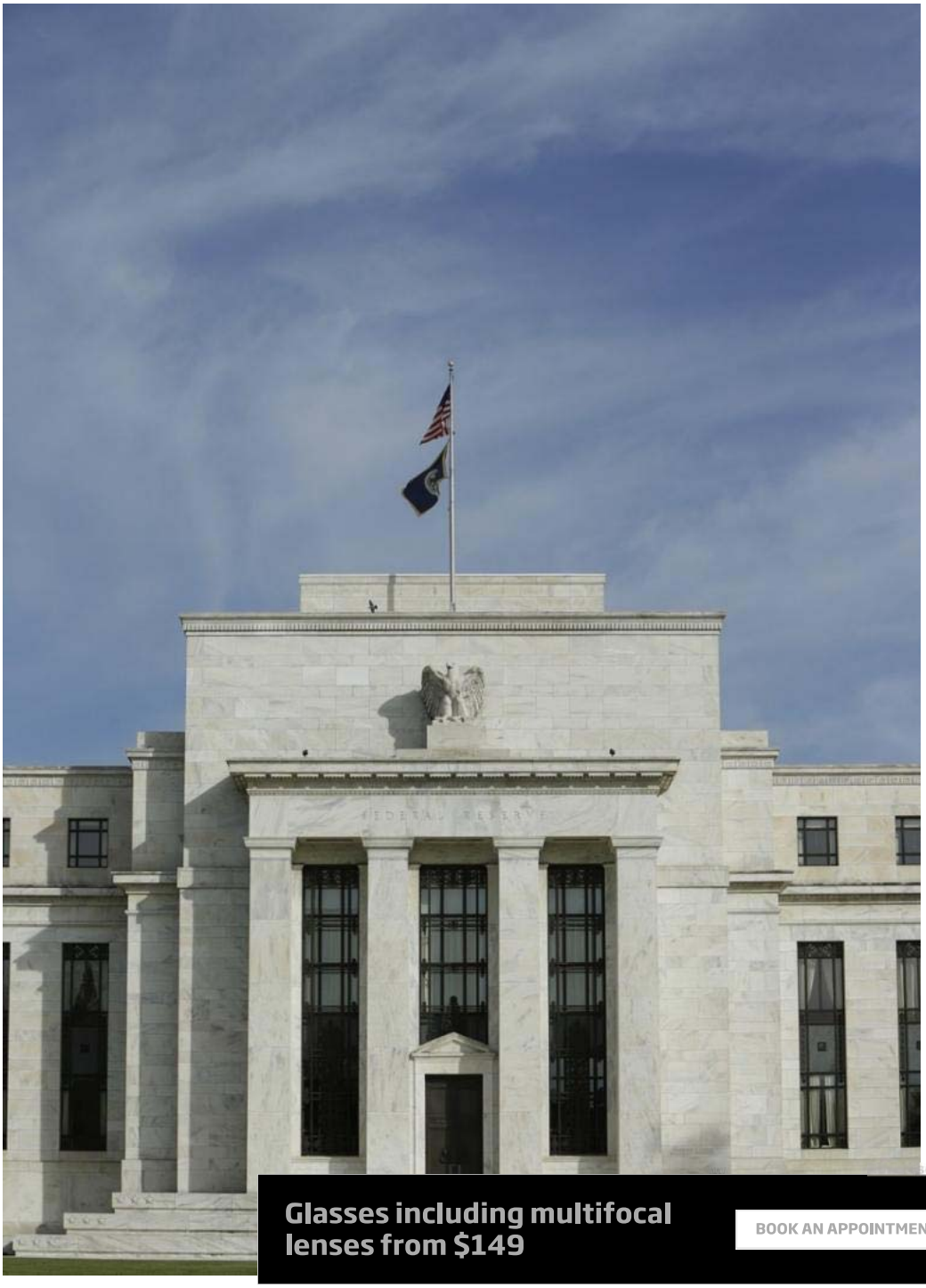
Be prepared for market change after US interest rates rise: RBA

By Susmita Pathak Mishra (/user/11757)
on September 17 2015 1:22 PM



The United States Federal Reserve Board building is shown in Washington October 28, 2014. The U.S. Federal Reserve this week will likely reinforce its stated willingness to wait a long while before hiking interest rates after a volatile month in financial markets

that saw some measure of inflation expectations drop worryingly low. REUTERS/Gary Cameron (UNITED STATES - Tags: BUSINESS POLITICS)

The rise in U.S. interest rates has been estimated by the Reserve Bank of Australia, or RBA, prompting the organisation to warn the public to be ready to deal with the changes.

RBA Assistant Governor Guy Debelle said on Wednesday that the U.S. rate of interest is likely to rise. “This is the most well telegraphed rate rise in the history of rate hikes,” he said. He added that if people are not ready for the change, then they will suffer financially.

The Federal Reserve is going to announce rate rise after a two-day meeting to be held on Thursday. The September policy meeting of the Federal Reserve will end on Friday morning (AEST). Debelle believes that there might be fluctuations in the global financial market as soon as the rate is hiked. People informed prior to the rise will, however, be able to deal with the situation properly.

He would have been more surprised if the process completely lacked volatility at the time of rising prices, Debelle told the Actuaries Institute Banking on Change Seminar held in Sydney. He said that whenever the U.S. rate of interest rises, things start settling down following the event. However, people have been warned earlier this time, which will make it easier for them to get ready for the financial upheaval.

The RBA official also reminded that it was in 2008 when the U.S. rates increased. Therefore, it might be difficult for some people to deal with it. “There’s a decent chunk of people in the market that have never experienced an environment where rates actually go up and most of them have never experienced an environment where rates actually change,” he told AAP (http://www.skynews.com.au/business/business/world/2015/09/16/us-rate-rise-coming--be-ready--rba.html) .

The U.S. bond returns on Tuesday night promptied significant rise in their level, which seems more than the yields recorded in the past four years.

The 12-member Federal Open Market Committee, or FOMC, think that the rate decision will be a close one. The committee holds an eight-fold meeting every year to decide on U.S. interest rates. It is concerned with setting targets for the Federal Funds rate as well as the key rate of interest between commercial banks, thereby affecting the cost of borrowing globally.

“There hasn’t been this much debate, uncertainty and division for a FOMC meeting in years,” BK Asset Management MD Kathy Lien said.

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Be ready for US hike: RBA's Debelle

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A Reserve Bank official has warned that a US interest rate rise is definitely coming and no one should be surprised.

"This is the most well telegraphed rate rise in the history of rate hikes," RBA assistant governor for financial markets Guy Debelle said on Wednesday.

"If you're not ready for it, you sure as hell have been warned."

The futures market has priced in a one-in-three chance the Federal Reserve will announce a rate rise after this week's two-day meeting and one is fully priced in for some time by next January.

The Fed's September policy meeting finishes early on Friday morning, Sydney time.

Dr Debelle expects some fluctuations in global financial markets when the Fed does lift the rate, but it should be contained.

"My guess is that I would be surprised if there wasn't a bit of volatility when they raise rates," he told the Actuaries Institute Banking on Change Seminar in Sydney.

"Every time we've had a rise in US interest rates in the past, things tend to happen after that."

However, it's been so long since the last US rate rise that some market players won't have the experience or know how to deal with it, Dr Debelle said.

"There's a decent chunk of people in the market that have never experienced an environment where rates actually go up and most of them have never experienced an environment where rates actually change," he said.

US bond yields on Tuesday night pushed to their highest level in more than four years, a sign more traders are betting on a US rate rise this week.

However, recent speeches by members of the Federal Open Market Committee (FOMC) show that this week's rate decision could be a close one.

"There hasn't been this much debate, uncertainty and division for a FOMC meeting in years," BK Asset Management managing director Kathy Lien said.

Sep 16 2015 at 12:08 PM | Updated 1 hr ago

APRA says big banks at risk from short-term, wholesale debt addiction

Australian Prudential Regulation Authority chairman Wayne Byres said local banks were not ready for the application of the "net stable funding ratio". **Michele Mossop**

by **James Eyers**

Banks will need to fund themselves with more long-term debt over time, the chairman of the banking regulator said on Wednesday - a move that would reduce the risk that the financial system will be exposed by seizures in short-term funding markets.

Australian Prudential Regulation Authority chairman Wayne Byres also indicated an increased focus on improving bank culture and remuneration, revealing a new team has been created within the regulator to push change within banks.

Mr Byres warned that Australian banks were not ready for the application of the "net stable funding ratio", which will come up for consultation with the industry in the coming months.

That ratio, one of the key reforms introduced by Basel Committee to create a more resilient banking sector, will be introduced in 2018. It requires banks to maintain a stable funding profile, which reflects the compositions of assets and activities and limits over-reliance on short-term, wholesale funding.

"Given their funding structures, the largest Australian banks don't easily meet the new standard, and as things stand today, international comparisons are not particularly favourable to them," Mr Byres said at an event at the Actuaries Institute in Sydney.

"So, some further lengthening of Australian bank maturity profiles is therefore likely to be needed over time, to truly strengthen their funding resilience."

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While banks have, since the financial crisis, reduced reliance on short-term funding, wholesale funding and offshore funding, they have not materially reduced reliance on short-term, wholesale funding from offshore, Mr Byres said. This is the very type of funding that the financial system inquiry chaired by David Murray said was the most risky, because it could disappear in a crisis.

"That might seem paradoxical, but as a percentage of total funding, short-term wholesale funding from offshore is virtually unchanged from a decade ago," he said.

"That is an important issue to address because the key rationale for the FSI's 'unquestionably strong' [capital] recommendation was the recognition that this funding issue has been a key vulnerability in the past."

His speech also addressed APRA's focus on enhancing bank culture, which follows a string of scandals in financial planning divisions and an investigation by ASIC over alleged rigging of benchmark interest rates.

APRA has written to bank boards of directors this year to emphasise the issue and Mr Byres said on Wednesday a new, small team had been set up to act as a "centre of expertise to drive our supervisory efforts in relation to governance, culture and remuneration, issues we think are highly interrelated".

He said that governance standards were reasonable but "on culture and remuneration we have more to do before we can be confident these will be genuinely supportive of long-term financial strength rather than, as we have seen in the past, possible threats to it."

Basel 3 also introduced a liquidity coverage ratio (LCR), which came into force for the larger banks this year and this had helped improve liquidity, Mr Byres said, although "the apparent ceasefire in the war for deposits means liquidity profiles have been strengthened less than might first appear".

He said the net stable funding ratio reforms in the coming years and the liquidity coverage ratio might ultimately have a larger impact on bank that the rules on capital levels. "These measures potentially have a greater impact on the Australian banking sector given its excess of loans over deposits and its reliance on wholesale funding than any of the changes to the capital framework."

Mr Byres also said Australian banks compare less favourably with international banks on leverage ratios, which divide Tier 1 capital by total assets. Even though the Australian banks remain above the 3 per cent minimum leverage ratio envisaged by Basel and the leverage ratio only serves as a backstop, "we shouldn't lose sight of it altogether".

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RBA deputy governor Guy Debelle says there's only one 'risk-free' rate

Reserve Bank assistant governor Guy Debelle says government bond yields can still be the basis for working out "risk-free" return rates. **Daniel Munoz**

by **Philip Baker**

Government bond yields have fallen to such record low levels since the financial crisis that some experts have questioned if it is still appropriate to use them when working out the "risk-free rate".

Guy Debelle, from the Reserve Bank of Australia, says the answer is yes, they are.

In financial theory, a lot hinges on the risk-free rate.

All assets are priced off it, companies can end up paying more for their money if the spread over the risk-free rate widens, while shares offer a "risk premium" in the form of a higher long-term return to make up for any short-term volatility.

Generally, it is the government bond that constitutes the risk-free rate and low bond yields over the past few years, for example, have gone a fair way to making shares look good value, enticing a range of buyers to get on board.

Low bond yields have also made the dividend yield on shares look attractive.

DISTORTED THE YIELD

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But central banks have distorted the yield on government bonds around the globe to such an extent that they have fallen to record lows and even at times into negative territory.

It has meant that some actuaries have wondered if the government bond rate is still the appropriate risk-free yield?

In a speech on Wednesday Debelle said ultimately the risk-free yield should be something that approximates the growth rate of the economy.

"On that basis, the government bond yield is still doing a pretty good job. Yes, policy actions in some of the major economies might have pushed the yield lower than it might otherwise have been. But those policy actions reflect the growth circumstance in which we find ourselves," he said.

For example, offshore investors have been large buyers of Australian government bonds since the crisis and it's one reason our yields are so low. However, Debelle doesn't see these purchases as distorting the yield, instead it just reflects "the reality of the world we live in".

Secular stagnation is another reason offered as to why growth rates will be lower than they used to be and in turn that will keep bond yields low.

There are a few theories of secular stagnation but in essence it means the rate of technology and innovation will slow down.

NO REASON TO GIVE UP

But Debelle finds that "very defeatist, and ultimately speculative. We simply don't know what the future will bring. There have been quite a number of times in the past where such a claim has been made which has subsequently been proven wrong. Maybe it's right this time, but I don't see any reason to give up yet."

So overall he still thinks the government bond yield is the best measure of the risk-free yield in the economy.

"There are some reasons to believe that it is now structurally lower than it used to be, but I find the proposition that the future rate of technological progress will be lower too pessimistic."

The other event having an impact on bond yields is of course the US Federal Reserve meeting this week.

On Tuesday night the US two-year bond yield, the bond most sensitive to a change in interest rates, hit 0.8 per cent, its highest yield in more than four years.

Even 10-year US bond yields rose to 2.3 per cent, the highest level in almost two months. Bond yields rise as prices fall.

POISED TO GO HIGHER

All will be revealed by the end of the week but after keeping interest rates at close to zero since 2008 the Federal Reserve is poised to raise them.

That means investors drunk on too much cheap money after a seven-year binge are

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on the cusp of starting their long, hard journey back to credit sobriety.

Although the move just has to be the most flagged rate rise of all time, it looks like the sharemarket is fighting it.

Not that the Federal Reserve should pay too much attention to the sharemarket but the S&P 500 has taken investors on such a rollercoaster ride since early July that there have been alternating returns for the past 10 weeks. That is one week up, the next week down.

The Federal Reserve has been warned not to raise rates now because of the wild ride on shares that some say is a signal that all is not well in the US economy.

But it's a small move, 25 basis points, and if not now, when? Just before Christmas?

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Need to adjust to changed bond market: RBA

- by: Mitchell Neems
- September 16, 2015 9:45AM

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Reserve Bank of Australia Assistant Governor Guy Debelle has outlined a trio of challenges facing the Australian economy, concluding there is a critical need to adjust to changes in the bond market.

Mr Debelle told the Banking on Change seminar in Sydney that all three issues -- bond market liquidity, long-term yields and China's exchange rate -- are important to financial markets in Australia.

"They are currently quite interrelated, with the rundown in China's foreign exchange reserves probably in part comprising sales of US treasuries and other sovereign bonds, because of their greater liquidity, thereby affecting global long-term yields," he said.

"We are seeing an unusual situation where a risk-off environment is associated with sales of the risk-free assets by a large market participant, rather than purchases."

Mr Debelle said the decline in bond market liquidity is, in part, a desired outcome of regulation, but said whether it has fallen is open for debate.

He added that the situation isn't going to change "any time soon".

"Market participants have to adjust their behaviour to deal with the current state of affairs," Mr Debelle said.

"They have to consider carefully how their execution strategies will function in an environment of lower liquidity and they may also need to adjust the construction of their portfolios accordingly."

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RBA's Guy Debelle says Australia should ready itself for financial aftershocks of US rate rise

- by: Paul Gilder
- From: The Courier-Mail
- September 16, 2015 8:06PM

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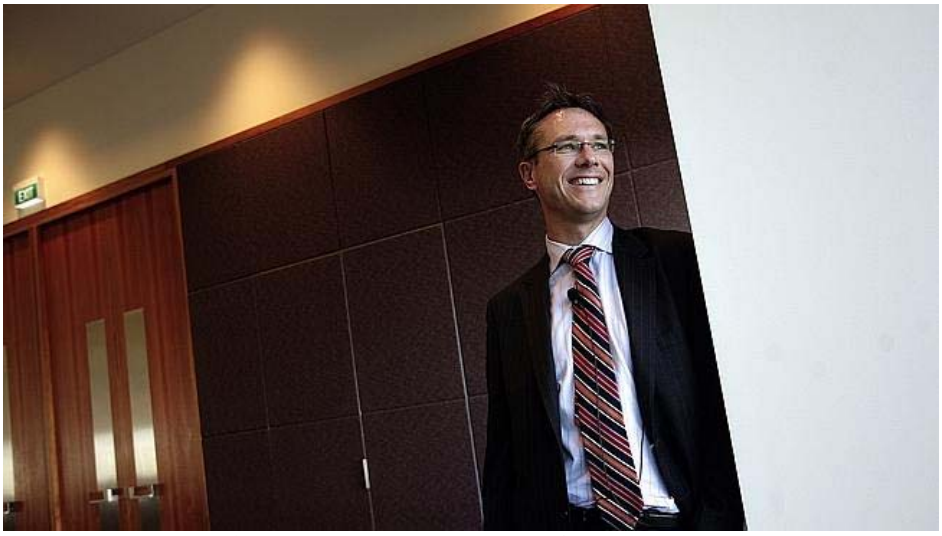

RBA assistant governor Guy Debelle. Pic:Luis Enrique Ascui/Bloomberg
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A LEADING Reserve Bank official has warned a long-awaited interest rate rise in the US is coming and Australia must ready itself for financial aftershocks.

Guy Debelle, the RBA's assistant governor for financial markets, said the impending rise was the "most well telegraphed" in history.

US central bankers last night started their two-day policy meeting, where they will decide whether their economy has sufficiently recovered from the global financial crisis to justify higher interest rates. Economists said if the Federal Reserve's Open Market Committee did pull the trigger, it was likely to start with a jump of 0.2 to 0.25 percentage points — the first rate rise in the US since 2006.

Investors are edgy because lifting rates from practically zero will herald an end to cheap credit, and developing economies that have borrowed in US dollars will pay more to service their debts.

Conversely, signs of a stronger US will boost Australia's export prospects.

Dr Debelle said the Fed had been preparing markets for an inevitable rate hike.

"If you're not ready for it, you sure as hell have been warned," he said.

Futures markets are pricing in a one-in-three chance of a move this week. It would be announced early tomorrow morning Melbourne time.

The chance of a move by December is rated as 62 per cent.

But Dr Debelle said he would be "surprised" if there wasn't some post-rise volatility, especially given the protracted period of inactivity on rates.

"There's a decent chunk of people in the market that have never experienced an environment where rates actually go up, and most of them have never experienced an environment where rates actually change," he told the Actuaries Institute's Banking on Change seminar.

Whatever comes this week, the Australian dollar is expected to gyrate and could hea swiftly below US70c should traders flock to the greenback.

The benchmark ASX 200 index climbed 1.6 per cent on Wednesday, reversing Tuesday's losses and closing just shy of 5100 points, while the dollar was fetching US71.53c.

In statements accompanying previous meetings of the Fed's rate-setting team, chairwoman Janet Yellen pointed out the importance of unemployment and inflation figures to the "lift-off" decision.

The US jobless rate is at a seven-year low of 5.1 per cent, while inflation remains the big question mark at a tepid 0.2 per cent as of July.

CMC chief market strategist Michael McCarthy said the Fed had laid the platform to proceed immediately.

"I'm calling lift-off now. They're looking at the economy over the next month and years, not the next week, so a bit of immediate volatility will be of no consequence to the Fed," Mr McCarthy said.

Others have pointed to jittery share markets in China, Japan and the US as a reason to hold off.

The OECD on Wednesday cut its world economic growth forecasts for 2015 and 2016, warning of a dramatic slowdown in Brazil and a global outlook clouded by uncertainty over China. The OECD, which had already slashed its economic forecasts just three months earlier, trimmed the 2015 growth forecast to 3.0 per cent from 3.1 per cent and the 2016 forecast to 3.6 per cent from 3.8 per cent.

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'Volatility will be higher. In itself, this is not necessarily a bad thing. It is what it is," says RBA assistant governor Guy Debelle. *Photo: Michel O'Sullivan*

The Reserve Bank of Australia official who oversees financial markets has a message for skittish bond traders who complain their market has become dangerous and illiquid: get used to it.

Speaking one day before the US Federal Reserve decides whether to lift rates for the first time in nine years, Guy Debelle told traders and investors to prepare for a new bond market order where volatility is almost certain to rise in times of stress. He also pushed back on calls for central banks to intervene if bond markets become too dislocated by assuming a 'market maker of last resort' role.

The Reserve Bank's assistant governor financial markets said the rise of algorithmic trading and the loss of appetite among investment bank trading desks' to step in and buy beaten up bonds in the hope of selling them later for a large profit meant the market was more volatile in times of stress.

"It continues to evolve but it is not going back to what it was any time soon. So participants in the bond market need to adjust to the current situation rather than simply complain about it," he said.

Debelle would not predict when the Fed would raise interest rates but said it was bound to increase market volatility.

"There is some stuff out there which is predicated on basically zero funding costs, that probably doesn't work when funding costs aren't zero, and it will probably fall over," he said.

"What it is is not entirely clear. Are we more confident it's not directly on the books of the core banking system? Yes... Will there be an increase in volatility? It would be surprising if there wasn't because historically that's always happened."

Given that it is nine years since the Fed raised interest rates, Debelle said a sizeable number of people in the market had not experienced an environment when interest rates were rising.

"We've had a long time of this sort of environment and some behaviours have probably evolved which are not going to be sustainable when rates are no longer at zero," he said.

"This is the most well telegraphed rate rise in the history of rate rises. So, if you're not ready for it, you sure as hell have been warned. You've got no excuse."

"The exact timing, in the end, really, is neither here nor there."

'Awkwardly named flash rally'

Debelle famously warned of rising volatility on the eve of the "awkwardly named flash rally" in US Treasuries that occurred in mid-October when bond yields plunged dramatically for 12 minutes before returning to previous levels.

That big move which lasted as long as "a well-timed coffee break" had become the subject of a report that was largely inconclusive as to the causes. But Debelle said "the fact that such events can occur in arguably the most deep and liquid market in the world does mean that we need to understand what is going on here."

The flash rally did highlight the prevalence of high frequency traders, who now account for about a third of the Australian bond market trading activity and a half in the larger US market.

The rise of computer traders meant there was plenty of liquidity to buy small parcels of bonds at prices close to the market but the depth of liquidity was poor as there were few buyers prepared to take larger parcels near the market price, creating a conundrum where liquidity was both good and bad simultaneously.

The lack of depth, Debelle explained is because of the withdrawal of banks which may have been unwilling to catch a falling knife and buy assets that were falling sharply in value, they did tend to be among the first to push against a selling tide. That has changed partly due to new regulation which means prices will deviate from fair value for longer periods and volatility will rise.

High volatility? 'It is what it is'

"Volatility will be higher," Debelle said. "In itself, this is not necessarily a bad thing. It is what it is. But with higher volatility, the distribution of price movements will have fatter tails. Over shooting will be more likely and that can have long-lasting and more deleterious consequences."

In this new world fund managers had to accept the bond market had changed, adapt the way they buy and sell bonds and manage their portfolios to handle unexpected redemptions.

Debelle also seemed to push back on calls for central banks to interject in times of market stress as a 'market maker of last resort', an extension of their function as a 'lender of last resort'. But he doesn't seem favourably disposed to such a responsibility.

"A market-maker makes two-way prices, both buying and selling. In a dislocated market, with most of the trading one-way, the central bank would only be buying, it wouldn't be selling the asset to anyone else anytime soon. A more appropriate description is buyer of last resort, with the risk to the central bank's balance sheet that comes from performing that role."

The China question

Debelle also offered thoughts on another big topic in the bond market – the liquidation of China's enormous $US4 trillion ($5.6 trillion) stockpile of foreign currency reserves held largely in the form of US treasuries and other government bonds.

To prop up its exchange rate as a result of capital outflows China has reduced its foreign currency reserves by almost $500 billion.

"We don't know what the Chinese are selling because we don't know the composition of their reserve holdings. But it probably involves some US treasuries and other sovereign bonds.

"Nor do we know what assets the private capital outflow from China is buying. But they are both huge orders of magnitude and are most certainly having a first order influence on financial markets."

The process represents a switch of ownership of assets from the public to the private sector as controls are lifted and Chinese invest abroad while the government had previously done so on behalf of its citizens.

"That is, a fair part of what is going on at the moment is a shift in who is holding foreign assets in China, not necessarily a large change in the total quantity of foreign assets being held by China. What matters for global financial markets is the difference in portfolio allocation between the public and private sector in China."

Australian dollar enjoys calm before Federal Reserve storm

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The Australian currency reached as high as US71.56¢ in early trade and, with few important local drivers, remained steady during the day. *Photo: Getty Images*

The Australian dollar edged slightly higher in a calm market before the storm blowing in from the US Federal Reserve meeting, which starts early Thursday Australian time.

In late local trade on Wednesday the Australian dollar was buying US71.44¢, compared with US71.13¢ at the same time on Tuesday.

The currency had dipped to a low of US70.85¢ just after midnight Australian time before a rally on Wall Street after strong US retail data drove up risk appetite and inspired Australian buying, Commonwealth Bank of Australia senior currency trader Elias Haddad said.

The Australian currency reached as high as US71.56¢ in early trade and, with few important local drivers, remained steady during the day.

"It is the calm before the storm before Friday morning's FOMC [Federal Open Markets Committee] meeting," Mr Haddad said.

A speech by Reserve Bank of Australia assistant governor financial markets Guy Debelle on Wednesday morning did little to shake the Aussie from its perch.

Mr Debelle said markets should not be surprised by a rate hike in the US, because it was the "most well-telegraphed rate rise" in history.

In agreement

Foreign exchange traders appeared to be in agreement, OANDA Australia and Asia Pacific senior trader Stephen Innes said.

While the market was predicting less than a one-in-three chance of a hike in September, "with pre-FOMC positions, squaring is the name of the game", he said.

In any case, the Australian dollar is likely to drop again when the Federal Reserve does begin its tightening cycle, although this will be offset by any further improvement in commodity prices and fading fears about China's equity markets and economic conditions.

Bristish-based Capital Economics, one of the foremost bears on the Australian economy, still expects the Aussie to decline as far as US60¢, as weak commodity prices continue to dent mining investment. Other sectors of the economy would be insufficiently robust to compensate for this ongoing downturn, chief Australia and New Zealand economist Paul Dales said.

"The weaker exchange rates are cushioning the blow from the plunge in export prices, but they won't outweigh the drag on overall gross domestic product growth," he wrote on Wednesday.

"With the boost to inflation from the weaker currencies also likely to be smaller than in the past, the combination of weak growth and low inflation will result in interest rates in both Australia and New Zealand being cut by more than the markets expect, to 1.5 per cent and 2 per cent respectively."

Across the ditch on Wednesday, the New Zealand dollar enjoyed a strong rally on dairy prices.

Hopes for a resurgence

The kiwi was given a 1.3 per cent boost after average winning prices in the GlobalDairyTrade auction rose 16.5 per cent to $US2568 a tonne, spurring hopes for a resurgence in dairy prices, which have languished because of lower demand, particularly from China.

The rally took the kiwi from US62.92¢ to as high as US63.11¢.

"However, I would not get too excited, given the fact global demand is not expected to swing higher any time soon," Mr Innes said.

Mr Haddad said he expected the Australian dollar to trade sideways until the outcome of the Federal Reserve decided at its meeting whether to lift interest rates for the first time since 2006.

"The caveat to that though is if we have some significant pullbacks in Chinese stocks again, but the major focus is on the US," he said.

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THE AUSTRALIAN

Crackdown not aimed at home prices: APRA

JASON CADDEN AAP SEPTEMBER 16, 2015 3:09PM

THE banking watchdog denies its crackdown on loans to housing investors was imposed to rein in soaring prices, but rather to improve lending standards.

AUSTRALIAN Prudential Regulation Authority chairman Wayne Byres said he was concerned that intense competition among lenders would lead to standards being eroded.

As a result, APRA took steps to rein in the number of loans being issued, including seeking to set a 10 per cent `speed limit' for banks on investor loan growth.

"It's often seen as some response to house prices. We've never said that is what we're trying to target. Indeed, it's impossible for APRA to target, or set, or even opine on what is the right level of house prices," Mr Byres said on Wednesday.

"We were just trying to get people to get their foot off the accelerator a bit because it was a means to preserve lending standards."

He said a 10 per cent limit on investor lending growth shouldn't be too much of an imposition for banks, but would ensure lending didn't get out of hand.

"Ten per cent growth is still, actually, a very healthy rate of growth in credit portfolios. It would still be the fastest growing part of the banks' loan books," he told the Actuaries Institute Banking on Change Seminar.

Mr Byres said that if loan growth got too hot then funding sources may become less reliable.

And, while Australian banks and other lenders had mostly turned to more reliable sources of funds in the aftermath of the GFC, reliance on overseas funding has not materially fallen, he added.

The financial system inquiry (FSI), chaired by David Murray, identified this funding as being most risky, because it could disappear in a crisis.

"The FSI's unquestionably strong recommendation was recognition this has been a key vulnerability in the past," Mr Byres said.

The APRA chairman reiterated the regulator's belief that the main way to improve the stability of the financial system was to change company cultures.