

Overview

Global financial conditions have improved significantly since the previous *Financial Stability Review*, despite the new uncertainty created by the proposed sovereign bailout for Cyprus in the past few weeks. Some earlier European policy initiatives had been seen as demonstrating a strong commitment to deal with the region's sovereign debt and banking sector problems while maintaining the monetary union, and this boosted confidence over much of the past six months. Confidence was also enhanced by further signs of recovery in some of the major economies, notably the United States, supported by continued monetary stimulus. The improvement in global financial market sentiment has contributed to a rally in risk assets across a range of markets, consistent with increased risk appetite.

The improvement in market confidence has helped ease sovereign financing pressures for a number of euro area countries that had been subject to the greatest concerns about debt sustainability. Given the links between sovereign and bank balance sheets, this had positive spillovers to bank funding markets in the region. The euro area nonetheless still faces significant challenges to its stability. Many banks, particularly in the periphery, are still experiencing elevated funding costs, deteriorating asset performance and weak profitability amid subdued economic and property market conditions. This has contributed to tight credit conditions in the region as banks continue to deleverage and reduce their balance sheet risks.

Given the unresolved vulnerabilities, it is too early to say whether the improved market sentiment over

the past six months is the beginning of a sustained recovery, or merely a temporary upswing. Much will depend on the European authorities' ability to implement the policy actions needed to restore confidence in debt sustainability and repair banking sectors, while also fostering a recovery in economic activity. In this context, the renewed market tension associated with the handling of the sovereign and banking crisis in Cyprus in recent weeks has provided a reminder of the political, economic and social challenges of resolving the pervasive fiscal and banking sector problems.

Outside the euro area, confidence in the major banking systems has also generally improved from six months ago, as evidenced by strong gains in bank share prices that have often exceeded the rise in broader share market indices. Even so, these banking systems are still at varying stages of their recoveries from the global financial crisis; subdued profitability and elevated non-performing loan ratios associated with slow economic activity and property markets continue to feature in many banking systems. Issues around loan forbearance and banks' asset valuations are also areas of concern in some countries.

Elsewhere, in countries that have been more resilient to the crisis, such as many in Asia, banking systems remain in a relatively strong position. Some of these countries, however, are beginning to confront a different set of challenges associated with property market and credit expansions. It is normal for the effects of low interest rates to be evident in asset prices and credit before they can be seen in economic growth and inflation, and

hence a prolonged period of low rates can result in a build-up of credit risk long before inflation starts to rise. In some countries, particularly those with limited exchange rate flexibility and strong capital inflows, the authorities have sought to contain these risks through macroprudential measures. These policy measures have had to be progressively tightened in a few cases in response to continuing credit and property market exuberance, illustrating some of the challenges involved in calibrating and targeting these policies.

The Australian banking system also remains in a relatively strong position. The improvement in global market sentiment since the middle of 2012 has, at the margin, eased wholesale funding costs for the large Australian banks, with bank bond spreads declining to around their lowest levels since the start of the crisis. The banks have been continuing to limit their use of wholesale funding in any case, and deposit growth has been outpacing growth in credit. Continued strong competition for deposits has seen spreads on retail deposits remain around historically high levels even as spreads on long-term wholesale debt have narrowed significantly over recent months.

The banks have collectively continued to record strong profits in recent periods, helping them to strengthen their capital positions further and putting them in a good position to meet the Basel III capital requirements that began to be introduced in Australia this year. The banking sector's asset performance has also been improving, though at a gradual pace due to the challenging conditions being experienced in some parts of the Australian and UK business sectors. With domestic demand for credit likely to remain moderate in coming years, banks are increasingly pursuing other strategies to underpin their profit growth over the medium term, such as efficiency improvements and expansion in the Asian region. While this remains an area to watch, there is little sign at this stage that banks have been motivated to take on excessive risk or strain their risk management capabilities.

Profitability in the general insurance industry was strong in the past year and the industry remains well capitalised. Underwriting results improved in a more benign claims environment following the sequence of catastrophe-related claims events in 2011. The natural disasters in Australia early this year are not expected to have a major financial effect on insurers.

A period of balance sheet consolidation has helped mitigate potential risks to financial stability emanating from the non-financial sectors in Australia. Even though the economy has been expanding at around trend rates, some firms have been facing challenges from the high exchange rate and a return to more traditional saving and borrowing behaviour by households. Consequently, business failure rates have been above average, which has contributed to the slow pace of recovery in banks' non-performing business loans over recent years; that said, the vast majority of firms are still meeting their debt commitments. Overall, gearing ratios are low and deleveraging is continuing in some parts of the business sector, which is helping to limit the effects of subdued activity and profitability in some industries.

Households' net wealth has been rising recently due to the recovery in housing and other asset markets as well as continued higher saving and borrowing restraint. Many households still prefer to repay existing debt rather than take on new debt, which has contributed to the slower pace of household credit growth and an increase in mortgage prepayment buffers. Debt-servicing capacity has also been boosted by lower interest rates. Despite the unemployment rate having drifted up a bit over the past year, housing loan arrears and other aggregate measures of financial stress in the household sector remain low. Household indebtedness and gearing are nonetheless still at historically high levels, and hence continuation of the household sector's more prudent approach to borrowing would assist in strengthening the sector's financial resilience.

After the fast pace of international regulatory reforms in the past few years, there has been more focus recently on implementation of the agreed reforms at the national level (particularly the Basel III capital standards) and monitoring the consistency of implementation internationally through various assessments and peer reviews. In Australia, the Australian Prudential Regulation Authority (APRA) finalised its implementation of the Basel III capital framework, which it began phasing in from the beginning of this year. APRA will shortly resume consultation on the Australian implementation of the Basel III liquidity reforms after a number of changes were made to the international standard earlier this year. Legislation was recently passed that will help Australia meet its G20 commitment to move toward greater central clearing and reporting of over-the-counter derivatives transactions. The members of the Council of Financial Regulators (CFR) have been continuing their work on strengthening Australia's financial sector crisis resolution arrangements, building on international best practice, with a particular focus recently on financial market infrastructures.

At the international level, policy development work has been progressing on a number of fronts, including addressing the risks posed by systemically important financial institutions and strengthening the oversight of shadow banking systems. As foreshadowed in the previous *Review*, the International Monetary Fund released its Financial Sector Assessment Program report on Australia in late 2012, which contained a positive overall assessment of financial system stability and supervisory standards in Australia. This report made a number of recommendations that are being considered by the relevant CFR agencies. ✎

