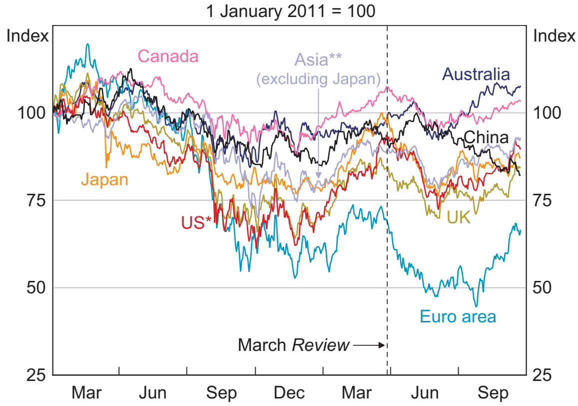
1. The Global Financial Environment

Since the March *Review*, global financial markets have been through another period of heightened risk aversion and volatility associated with an escalation of the euro area sovereign debt crisis and related banking sector problems. Greece and Spain have been a particular focus of market attention during this period. The difficulties these and other euro area countries are having in returning their fiscal positions to more sustainable paths and resolving banking sector problems have raised doubts about the viability of the monetary union. This contributed to further capital outflows from the most troubled countries and greater financial market fragmentation in the euro area. The pressures were evident around the middle of the year in rising yields on sovereign bonds issued by some of the most troubled euro area countries and declining euro area bank share prices (Graph 1.1). A weakening of economic activity in the euro area also contributed to the adverse feedback loop between sovereign and bank balance sheets. Outside the euro area, financial market sentiment in recent months was weighed down by the events in Europe, as well as concerns about the health of the global economy following the release of softer economic indicators in some large economies, including China and the United States.

Since August, there has been a marked improvement in global financial market sentiment, largely reflecting the European Central Bank's (ECB's) plans to intervene in sovereign debt markets to help preserve the euro area monetary union. The improvement has been reflected in the pricing of a range of risk assets,

Graph 1.1
Banks' Share Prices
1 January 2011 = 100



* Market capitalisation-weighted index of 18 large banks
** MSCI financials index
Source: Bloomberg

including declines in spreads on southern euro area sovereign bonds and increases in euro area bank share prices, which are now only a little below the level they were at the time of the previous *Review*. Despite the recent improvement, market confidence in euro area banks is still generally weak, and there are ongoing concerns about some banks' solvency. Confidence in the global financial system remains fragile and susceptible to further setbacks in dealing with the euro area crisis or a further softening in global economic growth.

The Euro Area Crisis and Sovereign Debt Markets

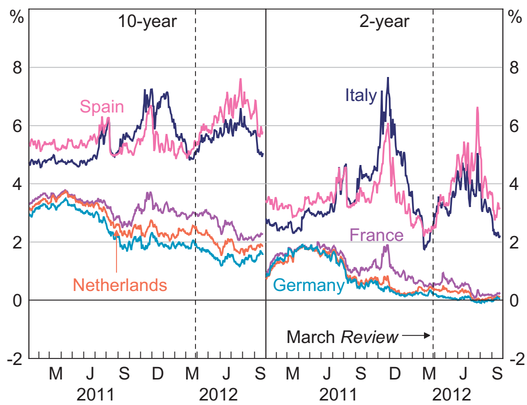
The euro area sovereign debt and banking crisis has been a continued source of market concern during the six months since the previous *Review*.

Developments in Greece and Spain, in particular, sparked renewed market stress in Europe at various points between April and July. In the lead-up to the elections in Greece, concerns that its bailout package might not be adhered to prompted speculation that the country may exit the euro area. Deposit outflows accelerated at Greek banks as depositors sought to avoid redenomination risk. These concerns eased somewhat after parties supportive of the bailout package were elected in June, but market participants remain doubtful that Greece can meet the terms of its package and continue to receive financing, given that economic conditions are still deteriorating. The risk that Greece might exit the euro, imposing losses on holders of financial contracts in Greece and possibly spurring contagion to other countries, therefore continues to weigh on asset prices in the region.

In Spain, the recent concerns have mostly been about the weakness of its banking system and what this might mean for its deteriorating public finances. Spanish banks have been suffering from poorly performing property exposures and weak economic conditions for a few years now, and the part-nationalisation of Spain's third-largest bank (BFA-Bankia) in May triggered renewed market concerns about their position. Spanish sovereign and bank bond yields rose sharply, and the Spanish banking system further increased its reliance on central bank liquidity (Graph 1.2). The Spanish authorities took a number of steps to shore up confidence in the system, including strengthening provision requirements on still-performing property development loans and commissioning independent stress tests of the banks. In June, Spain sought financial assistance from the European Union (EU) of up to €100 billion to help recapitalise troubled Spanish banks, and the European authorities formally agreed to this in July. Stress tests to determine the capital needs of individual Spanish banks are due to be released around the end of September. Spain also recently announced that it will establish a 'bad bank' later this year to remove certain non-performing assets from the balance sheets of Spanish banks that have received public funds, and manage these assets over time.

While investors initially responded favourably to the announcement of the Spanish bank bailout package, market sentiment quickly reversed as attention focused on the increase in government debt this funding would entail. Together with the poor state of regional government finances in Spain, this contributed to fears that a more comprehensive sovereign bailout package would be required, along the lines of those already provided to Greece, Ireland and Portugal. In this environment, attention naturally also turned to Italy because of the state of its public finances, and Italian sovereign (and bank) bond yields rose around the middle of the year. Meanwhile, in June, Cyprus became the fifth euro area country to request international financial assistance when it asked for funds to help recapitalise its banking system (which has significant exposures to Greece) and finance its budget deficit. In contrast to these developments in southern Europe, government bond yields for northern euro area countries continued to decline over the past six months, with German and Dutch short-term yields recently falling below zero. This largely reflects safe-haven flows given these countries' better fiscal positions.

Graph 1.2
Euro Area Government Bond Yields



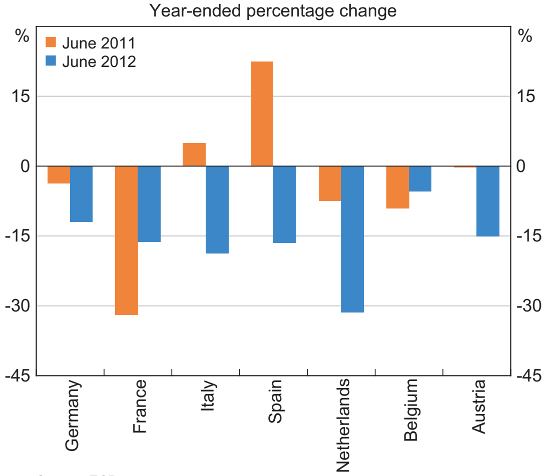
Source: Bloomberg

As recent events added to broader doubts about the viability of the monetary union, there was a general move to reduce cross-border exposures within the euro area. This was evident in significant capital outflows from some troubled euro area countries over the past year: foreign holdings of these governments' debt declined sharply; euro area banks reduced their holdings of debt (mainly government and bank debt) issued outside their home jurisdictions (Graph 1.3); and non-domestic depositors withdrew funds from banks in most euro area countries (Graph 1.4). Cross-border financial institutions have been seeking to match their liabilities and assets in individual euro area countries more closely, to protect themselves if one of these countries should exit the euro. In particular, banks have been reducing funding shortfalls in the more troubled euro area countries by further cutting back their exposures there, reinforcing broader efforts to deleverage and refocus on their core activities. Some European banks have reportedly increased their borrowing from national central banks in the host countries where they have subsidiaries and branches, rather than from the central bank in their home country as was typical in the past.

Graph 1.3

Banks' Holdings of Non-resident Euro Area Bonds

Year-ended percentage change

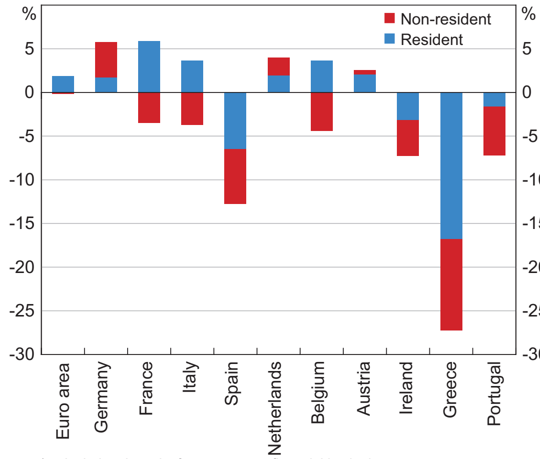


Source: ECB

Graph 1.4

Change in Private Sector Deposits*

Year to June 2012, per cent



* Includes deposits from monetary financial institutions

Source: Central banks

European authorities have announced a number of measures in recent months to help alleviate market strains and keep the euro area intact. In early August, the ECB said that it was considering purchasing short-term sovereign debt in secondary markets, given its view that the exceptionally high risk premia observed in some sovereign debt markets and the associated financial fragmentation are hampering the transmission of monetary policy in the euro area. The details of a new sovereign bond-buying program, known as Outright Monetary Transactions (OMT), were released in September. The ECB will only purchase sovereign debt of euro area countries that have an EU assistance program and are meeting the attached policy conditionality. There will be no *ex-ante* limit on purchases, which will be focused on the shorter end of the yield curve, particularly securities with 1–3 year residual maturities. The ECB's holdings will rank equally with existing senior creditors, in contrast to the position taken in the Greek debt restructuring.

While the OMT has yet to be activated, the ECB's announcements have contributed to a marked narrowing of spreads on southern euro area sovereign bonds, particularly at the shorter end of the yield curve. The Spanish Government is considering requesting EU financial assistance in order to qualify for the OMT, but have reserved their decision until it is clearer what policy conditionality would be attached; Italian officials have said that an assistance program for Italy is not warranted at this stage. While the ECB's decision to support sovereign debt markets should improve financing conditions in the euro area, it does not resolve underlying debt sustainability problems. Continued progress towards fiscal sustainability (and further bank balance sheet repair) will therefore be necessary to avoid further bouts of market volatility in response to economic and political setbacks.

European policymakers have also taken steps to more closely integrate the region's financial regulatory structure. The European Commission recently announced plans to phase in a new single supervisory mechanism in the euro area, whereby the ECB would assume ultimate responsibility for the supervision of all euro area banks by 2014 and national supervisory authorities would continue to undertake day-to-day supervisory activities. This proposal is aimed at ensuring that bank supervision is applied consistently across the euro area, and has a region-wide focus. Centralised oversight by the ECB might also make it feasible for the euro area's permanent bailout fund, the European Stability Mechanism, to be given the authority to recapitalise banks directly rather than by channelling funds through sovereigns. A direct approach would avoid raising the debt of already strained sovereigns and could thereby help curtail the adverse feedback loop between bank and sovereign balance sheets. A new supervisory structure will take some time to put in place, though, as it will involve difficult reallocations of supervisory resources. A complete banking union will also require integrated deposit insurance and resolution mechanisms, and in the longer run, deeper fiscal integration; these reforms could prove more difficult to achieve politically.

As the uncertainties in the euro area increased investor risk aversion, government bond yields in a range of advanced countries outside the region (including Australia) generally continued to decline over the past six months (Graph 1.5). In addition to safe-haven flows, central bank bond purchases as part of quantitative easing programs have helped reduce yields in the United Kingdom and the United States.

Graph 1.5
Government Bond Yields

Source: Bloomberg

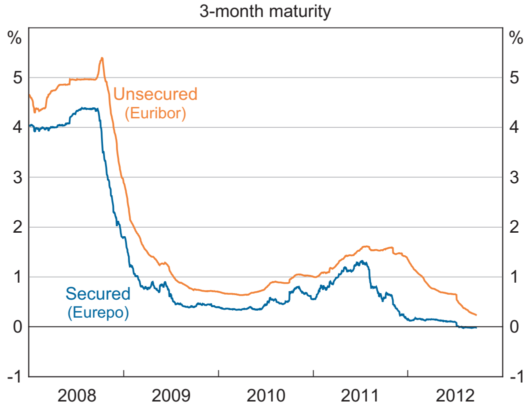
Government debt and deficits are also high in the United States and Japan, and the International Monetary Fund projects the ratios of these countries' government debt to GDP to reach very high levels within a few years. Because these countries have their own currencies, they do not face the same risks of a sudden loss of investor confidence in their fiscal positions and resulting capital outflows as do members of a currency union like the euro area. A more imminent risk to global financial stability from this quarter would be if fiscal policy were tightened severely enough in the short term that it significantly weakened economic growth: if not handled appropriately, the so-called 'fiscal cliff' facing the United States next year could be a trigger for such a scenario. That said, a sudden increase in government bond yields cannot be ruled out. At current low interest rates, even an increase in yields to the levels of a few years ago would impose sizeable mark-to-market losses on banks and other investors. Liquidity pressures could also ensue in some markets if a fall in bond prices and/or a credit rating downgrade required more collateral to be posted to counterparties.

Bank Funding Conditions and Markets

ECB policy actions and announcements over the course of the year have brought interbank borrowing costs down, but overall funding conditions for banks in the euro area remain strained. The ECB cut the rate it pays on its deposit facility from 0.25 per cent to zero in July, in an attempt to stimulate activity in short-term interbank markets. Despite these actions, the volume of interbank lending remains weak, especially across borders, and even in secured lending (repo) markets, liquidity has been low. Concerns about counterparty risk and collateral quality have also resulted in greater differentiation in lending rates across banks, which has been inhibiting the transmission of euro area monetary policy. As some securities are now seen as lower quality and a significant portion of the remaining high-quality collateral has been pledged to the ECB, the pool of unencumbered high-quality assets available to euro area financial markets has declined at the same time as demand for these assets as collateral has been particularly strong. As a result, repo lending rates involving these assets have been slightly negative over recent months (Graph 1.6).

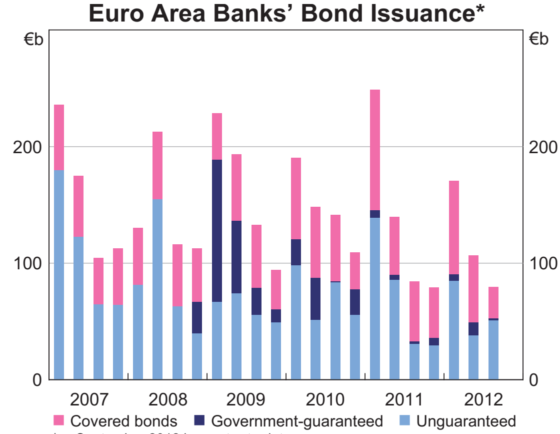
Conditions in term funding markets have also been relatively subdued. Euro area banks have issued around €185 billion of bonds since April, compared with €225 billion in the same period last year, though there has been a pick-up in issuance activity since the details of the ECB's OMT program were announced in early September (Graph 1.7). A significant share of bond issuance over the past six months has been retained by banks to provide them with additional collateral for central bank funding. While some banks have not needed to issue as much debt this year because they obtained ample three-year funding in the ECB's earlier refinancing operations, many banks have seen their market access curtailed, especially for unsecured debt. Some banks in Cyprus and Spain, in particular, have been forced to rely more heavily on collateralised borrowing from the ECB or their national central bank given their difficulties accessing term markets (Graph 1.8). The ECB broadened further the range of collateral eligible for its liquidity operations over recent months as some banks' collateral had reportedly been depleted. The increased reliance of many euro area banks on central bank funding could eventually complicate exit strategies, especially if banks are not able to return to wholesale markets by the time the large stock of three-year loans from the ECB matures in 2015.

Graph 1.6
Euro Interbank Interest Rates
3-month maturity



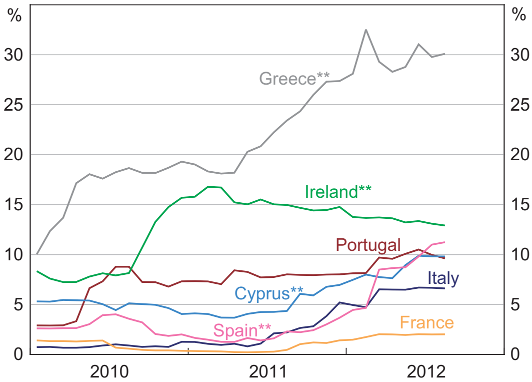
Source: Bloomberg

Graph 1.7
Euro Area Banks' Bond Issuance*



* September 2012 is quarter-to-date
Sources: Bloomberg; Dealogic; RBA; Thomson Reuters

Graph 1.8
Central Bank Lending to Banks in Selected Euro Area Countries
By national central bank, share of national total bank assets*

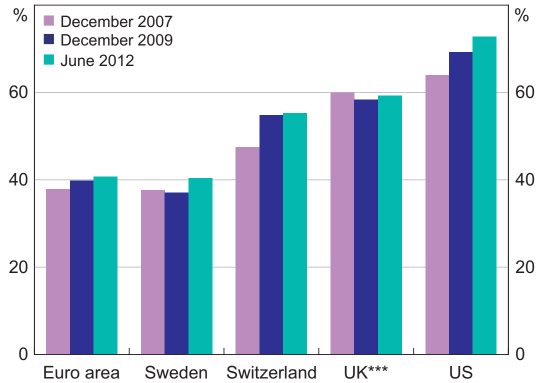


* Banks proxied by credit institutions except Cyprus, France and Portugal which use the broader category of monetary financial institutions
** Includes estimate of emergency liquidity assistance
Sources: RBA; central banks

As euro area banks have increased their collateralised borrowing from the ECB and become more reliant on covered bonds and other forms of secured funding, concerns have also been raised about their increasing asset encumbrance. The structural subordination of unsecured creditors that this entails could ultimately result in higher unsecured funding costs for banks in the future. Accordingly, there have been calls for banks to improve their reporting on asset encumbrance to address some of the market uncertainty. Over the longer term, unsecured debt holders' concerns about potential subordination and lower recovery rates may also be exacerbated by the introduction of bail-in and other resolution options in Europe that are currently being developed.

The euro area problems have been contributing to periods of volatility in wholesale funding markets for banks in other countries for some time, though these spillover effects have generally been fairly limited. Bank bond spreads rose in April and May across a number of markets, though they remained well below levels seen in late 2011, and have since declined. Bank bond issuance outside the euro area has remained subdued over recent quarters given the market volatility and slow credit growth in most countries. Banks in a number of major markets have also been increasing the share of their funding from customer deposits over recent years, thereby reducing their reliance on less stable market-based funding, particularly short-term wholesale debt (Graph 1.9). This has contributed to higher funding costs as banks replace cheaper wholesale funding with more expensive customer deposits and term debt.

Graph 1.9
Customer Deposit Funding*
Share of total funding**



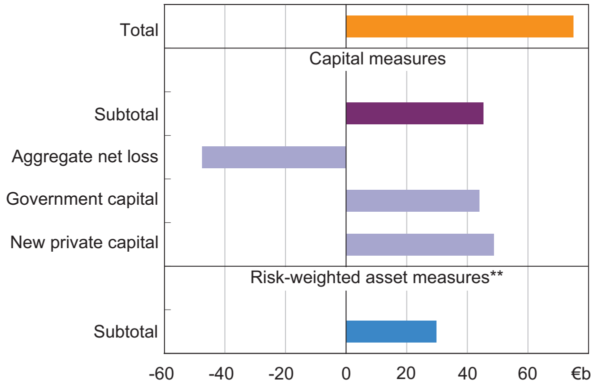
* Total deposits excluding deposits from banks and other monetary financial institutions; ratios across banking systems are subject to definitional differences; certificates of deposit are classified as wholesale debt in all countries except the US, where these instruments are eligible for deposit insurance
** Total liabilities including equity less derivatives and other non-debt liabilities
*** December 2007 and December 2009 data are for banks, while June 2012 data are for all monetary financial institutions
Sources: FDIC; central banks

Banks' Capital Positions

Euro area banks have continued to strengthen their capital positions in response to market and regulatory pressures. In aggregate, the large euro area banks increased their core Tier 1 capital ratio by 1.2 percentage points (or about €75 billion) over the year to June 2012, to 10.5 per cent (Graph 1.10). The majority of this increase came from higher capital levels, mainly retained earnings and the conversion of hybrids to common equity; there was little issuance of new equity given depressed share prices in the region. Most of the large European banks did not require government assistance to meet the target imposed by the European Banking Authority (EBA) of a 9 per cent core Tier 1 capital ratio by June 2012, plus a buffer to allow for valuation losses on their EU sovereign exposures. However, given their

Graph 1.10
Change in Euro Area Banks' Core Tier 1 Capital*

Year to June 2012

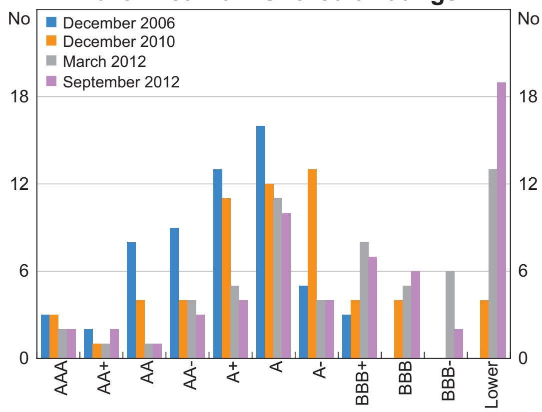


* 44 large banks from across the euro area; latest available data used where banks have not reported for June 2012

** Capital equivalent effect of changes in risk-weighted assets

Sources: SNL Financial; banks' annual and interim reports

Graph 1.11
Euro Area Banks' Credit Ratings*



* Fixed sample of 60 large institutions from across the euro area; predominantly Standard & Poor's local long-term ratings, unless unrated, then Moody's senior unsecured

Sources: Moody's; RBA; Standard & Poor's

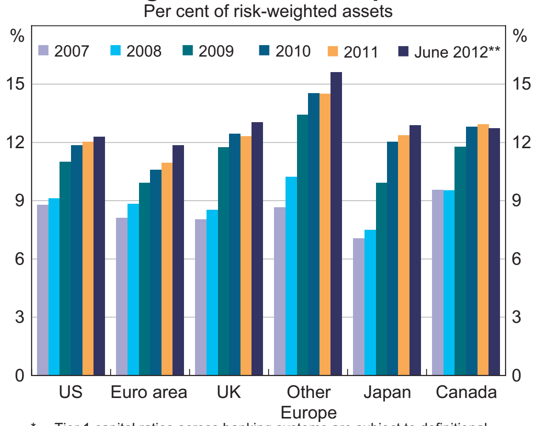
sizeable losses, a number of banks from the most troubled euro area countries required government capital injections to meet the target. A decline in risk-weighted assets of about 4 per cent also boosted the euro area banks' aggregate capital ratio over the year to June. Total assets fell by less than risk-weighted assets, mainly due to banks' shedding assets with above-average risk weights.

Despite the recent steps to strengthen capital positions, market confidence in many euro area banks remains low. This reflects ongoing doubts about the asset quality and hence solvency of some banks, particularly those from the most troubled euro area countries where economic activity is quite weak. This has been evident in various market indicators, including elevated bond and credit default swap premia, as well as low credit ratings. Indeed, around one-third of a sample of large euro area banks are currently rated sub-investment grade (Graph 1.11). More broadly, euro area banks' equity valuations remain at very low levels, despite increases in bank share prices over the past couple of months.

Large banks outside the euro area have also continued to strengthen their capital positions over recent periods (Graph 1.12). This has mainly been through retaining earnings, in many cases

Graph 1.12
Large Banks' Tier 1 Capital*

Per cent of risk-weighted assets



* Tier 1 capital ratios across banking systems are subject to definitional differences; includes the weighted average of: 19 large US banks, 52 large institutions from across the euro area, the four largest UK banks, 13 large other European banks, the three largest Japanese banks and the six largest Canadian banks

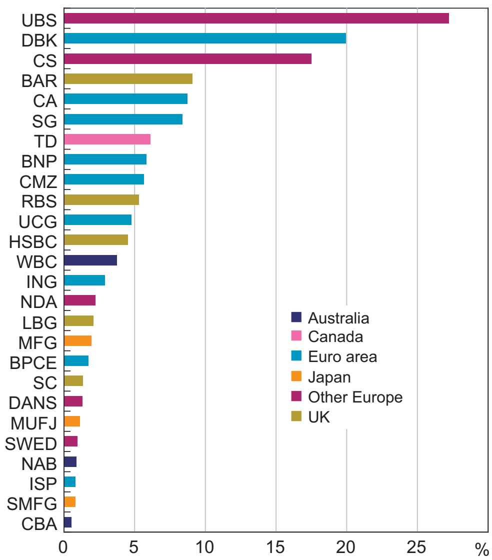
** July 2012 used for Canada; latest available data used where banks have not reported for June 2012

Sources: Bloomberg; FDIC; RBA; SNL Financial; banks' annual and interim reports

supported by dividend payout ratios that are still below pre-crisis levels. Many banks have been able to increase their capital ratios even though the introduction of Basel 2.5 capital rules raised risk weights for certain trading book assets and securitisations. The revised capital standards, which have been implemented in all major jurisdictions except the United States, particularly affected banks with large capital markets businesses, among them some large European banks (Graph 1.13).

Although large banks in the major advanced countries have significantly strengthened their balance sheets over the past few years, many will need to take further action to meet the tougher regulatory requirements that are being phased in over coming years. In particular, many banks need to increase common equity positions to meet the Basel III capital requirements, as well as the extra capital buffers that will apply to those banks deemed systemically important. The Basel Committee on Banking Supervision estimated that, as at December 2011, the world's largest banks required a total of around €370 billion in extra capital (equivalent to about 2½ per cent of their risk-weighted assets) to meet the Basel III minimum capital requirements.[1] Even though most banks have increased their capital ratios since then, some still have further to go. Many banks also need to alter their funding structures to meet the Basel III liquidity and funding ratios.

Graph 1.13
Increase in Risk-weighted Assets due to Basel 2.5
December 2011*



* January 2012 for Canadian banks and March 2012 for Australian banks
Source: Banks' financial disclosures

Improving capital and funding positions will take time to achieve and banks therefore need to be transitioning now. Because banks' progress will come under market and supervisory scrutiny, laggards run the risk of being forced to take quicker and potentially more drastic action at a later date. Raising capital or retaining earnings to meet higher capital requirements will be difficult for banks with depressed share prices and weak earnings prospects, so many of them are still looking to deleverage by reducing assets and exiting capital-intensive businesses. This is reflected, for example, in the current plans of large European banks to reduce their aggregate risk-weighted assets by about 7–8 per cent by 2015. They have targeted their biggest reductions at corporate and investment banking, but also exposures to parts of Europe where economic conditions are weakest. The overall effect of this deleveraging on financial conditions and markets is likely to be noticeable, but limited by the fact that a number of banks headquartered outside Europe are looking to expand into certain markets where European banks are pulling back.

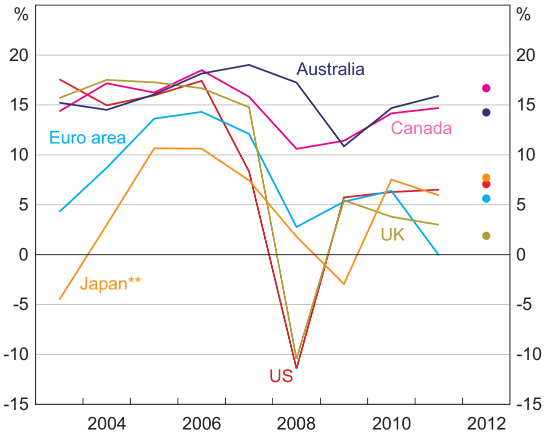
Bank Profitability

The profitability of the major banking systems remains subdued. Annualised returns on equity for the largest banks in euro area, Japan, the United Kingdom and the United States averaged 2–8 per cent in the first half of 2012, well below the rates recorded prior to 2008 (Graph 1.14). Returns were broadly unchanged from those recorded in 2011, with the exception of the large euro area banks, whose average returns in 2011 were held down by sizeable write-downs on their goodwill and Greek sovereign exposures. Many of the smaller and more domestically focused banks in the weakest economies in Europe have recorded large losses in recent reporting periods.

The recent modest profitability of large banks in the major advanced economies reflects a number of

1 Basel Committee on Banking Supervision (2012), 'Results of the Basel III Monitoring Exercise as of 31 December 2011', September, p 2.

Graph 1.14
Large Banks' Return on Equity*
After tax and minority interests



* Return on equity of the six largest US banks, eight largest listed euro area banks, four largest UK banks, three largest Japanese banks, six largest Canadian banks and four largest Australian banks; adjusted for significant mergers and acquisitions; 2012 profit is annualised and total equity is assumed constant from last reporting date

** 2003–2007 results are to financial year ended 31 March

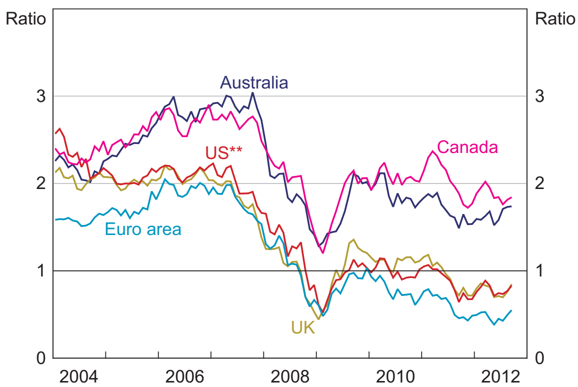
Sources: Bloomberg; RBA; banks' annual and interim reports

factors. Most banks have recorded little or no growth in net interest income, with credit growth remaining weak and net interest margins being weighed down by higher funding costs and the prolonged low interest-rate environment. Investment banking income has also been under pressure as volatile financial market conditions reduced trading revenues and demand for capital markets services. While declines in loan-loss provisioning have boosted profits of large UK and US banks in recent reporting periods, some euro area banks' provisions have risen due to deteriorating economic conditions within the region and ongoing weakness in the Spanish property market. Some large banks have also incurred significant legal/regulatory expenses arising from previous inappropriate business practices, such as poor mortgage practices in the United States, the mis-selling of payment protection insurance in the United Kingdom, and the recent LIBOR manipulation scandal. JP Morgan recently recorded large trading losses on its synthetic credit portfolio, highlighting the consequences of inadequate risk controls and unconventional investment strategies. A further factor contributing to lower returns on equity is that the large banks are holding higher levels of capital now, as noted earlier.

Recent returns recorded by the large banks in the major banking systems are well below those typically demanded by equity investors, as well as banks' own targets. Investors also appear to be expecting banks' profitability to remain subdued, with market valuations of banks' equity well below book valuations – that is, banks' price-to-book ratios are below 1 (Graph 1.15). Consistent with these low equity valuations, equity analysts are forecasting the large global banks to post average returns on equity of 5–7 per cent for 2012 as a whole, and only slightly higher returns in 2013; these forecasts were revised down during the past six months as the global macro-financial environment deteriorated (Graph 1.16). Low equity valuations may also reflect some investor scepticism over banks' asset valuations and/or an additional risk premium required by investors to compensate for heightened uncertainty. These concerns are likely to be especially relevant for euro area banks at the current juncture.

In contrast to many of their international peers, the profitability of the large Canadian and Australian banks has remained robust over recent periods, with returns on equity generally averaging around 15 per cent, consistent with stronger economic and

Graph 1.15
Banks' Price-to-book-value Ratios*

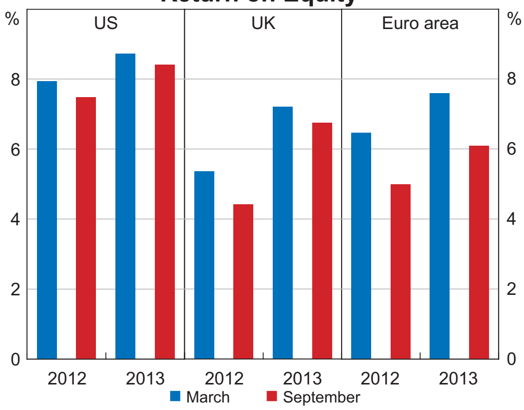


* Monthly; September 2012 observation is the latest available

** Diversified financials

Source: Bloomberg

Graph 1.16
Analysts' Forecasts of Large Banks' Return on Equity*



* Simple average of consensus forecasts of banks' annual return on equity; includes the six largest US banks, the four largest UK banks and the eight largest listed euro area banks

Source: Bloomberg

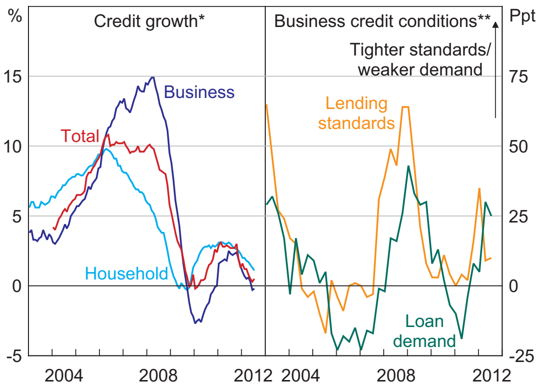
financial conditions in their home markets (see 'The Australian Financial System' chapter). Analysts are forecasting these banks' returns to remain at similar levels in 2013. The more favourable earnings outlook for large Canadian and Australian banks, along with the healthier state of their balance sheets, is reflected in equity valuations that are close to long-run average levels, unlike in many other advanced countries.

Credit Conditions and Asset Quality

Weaker economic activity and difficult funding conditions in the euro area have been associated with falls in region-wide credit during the first half of 2012, and little growth in credit over the past year (Graph 1.17). Credit conditions continued to tighten in the region during the first half of the year as banks passed on higher funding costs and toughened non-price loan terms. The ECB's bank lending survey showed a net balance of banks tightened their business and household loan standards in the March and June quarters, albeit less so than in late 2011. Credit demand by households and businesses has been contracting more sharply than in late 2011, with investment intentions likely being pared back because of the weak economic outlook and, in some cases, tighter financing conditions.

Weakness in credit growth has been most pronounced in the troubled euro area economies; credit declined over the past year by around 4–5 per cent in Greece, Ireland, Portugal and Spain. Supply-side factors are likely to have contributed to this. For example, interest rates on new bank loans to non-financial corporations have increased noticeably since 2011 in these countries (as well as in Italy), whereas they have generally fallen in northern euro area countries in line with the lower ECB policy rate (Graph 1.18). Divergence in interest rates across euro area countries has been most evident for small business loans, given their higher risk. As they

Graph 1.17
Euro Area Credit Conditions

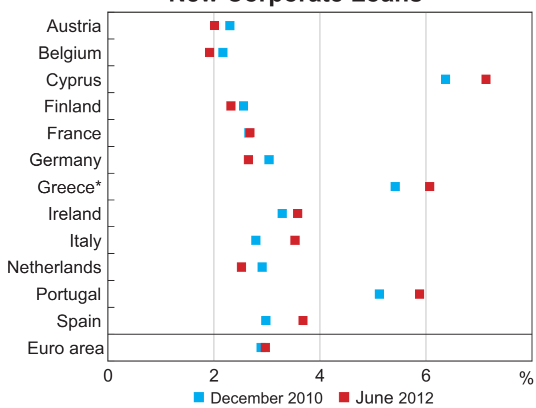


* Year-ended percentage change; credit growth series not adjusted for securitisations prior to 2009

** Net percentage of respondents reporting tighter standards/weaker demand

Sources: ECB; RBA

Graph 1.18
Average Interest Rates on New Corporate Loans



* Interest rate on outstanding corporate loans

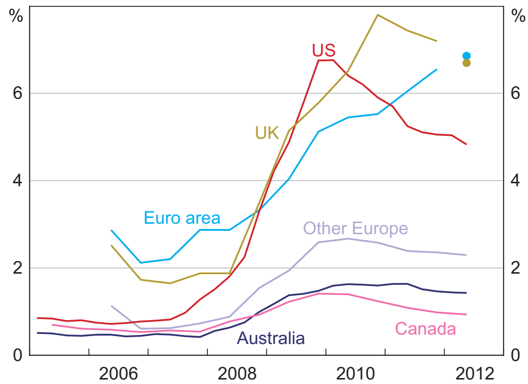
Source: ECB

do not have access to alternative sources of debt finance via capital markets, tight lending conditions for small businesses could have a negative effect on economic activity within the region, with the potential for adverse second-round effects on banks' asset performance. Even some large businesses in the euro area currently have more limited access to capital markets than usual because of the current low credit ratings of their sovereigns.

Banks' asset quality has come under continued pressure in the euro area as economic and financial conditions have weakened to a point that is similar to the adverse scenario used in last year's EBA stress tests. The large euro area banks' average non-performing loan (NPL) ratio increased significantly over 2011 and the first half of 2012, in contrast to most other jurisdictions where NPL ratios have continued to drift down from crisis peaks (Graph 1.19). Average NPL ratios are currently highest for Cypriot, Greek, Irish and Italian banks, but a number of banks from other countries in the region also have very high ratios (Graph 1.20). There is also significant market concern about the asset quality of many Spanish banks given that property prices continue to decline in Spain and current property valuations may come under further downward pressure because of future asset purchases by the 'bad bank' being introduced in Spain.

In the United States, banks' NPL ratios have trended lower over recent quarters, in line with the gradual improvement in parts of the US economy. Non-performing ratios for commercial and consumer loans have now declined to around their long-run average levels, while the ratio for commercial real estate loans has fallen sharply, consistent with the partial recovery in commercial real estate prices (Graph 1.21). In contrast, residential real estate NPLs remain at very high levels of around 8 per cent; although around one-fifth of housing loans are estimated to be in negative equity given the decline in housing prices. There are tentative signs of a recovery in the housing market, with prices rising mildly over the past few months. That said, risks to economic growth in the United States are skewed to the downside and any deterioration in economic conditions could stall this nascent recovery. Concerns over the strength of the US economic recovery and the labour market have prompted the US Federal Reserve to announce plans to undertake further monetary stimulus by purchasing asset-backed securities.

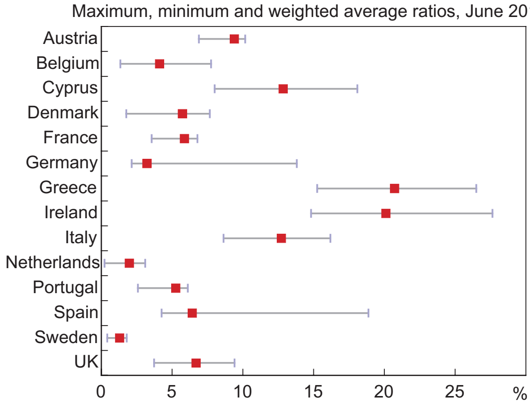
Graph 1.19
Large Banks' Non-performing Loans*
Share of loans



* Definitions of 'non-performing' differ across jurisdictions, and in some cases exclude loans that are 90+ days past due but are not impaired; includes 18 large US banks, 52 large institutions from across the euro area, 13 large other European banks, four UK banks, the six largest Canadian banks and the four largest Australian banks; latest available ratios have been used for some euro area and UK institutions where June 2012 data are unavailable

Sources: APRA; RBA; SNL Financial; banks' annual and interim reports

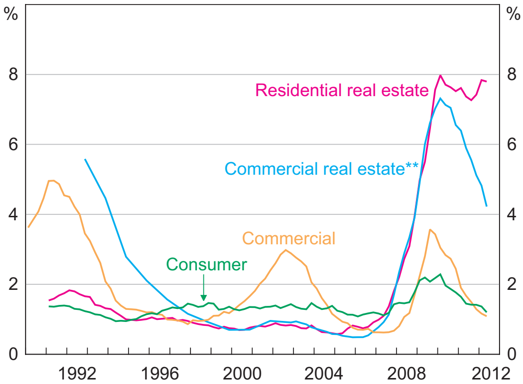
Graph 1.20
Large European Banks' Non-performing Loans*
Maximum, minimum and weighted average ratios, June 2012



* Definitions of 'non-performing' differ across jurisdictions, and in some cases exclude loans that are 90+ days past due but are not impaired; latest available ratios have been used for some institutions where June 2012 data are unavailable

Sources: SNL Financial; banks' annual and interim reports

Graph 1.21
US Non-performing Loans*
Share of loans, by loan type



* FDIC-insured institutions
** Includes construction and development loans
Source: FDIC

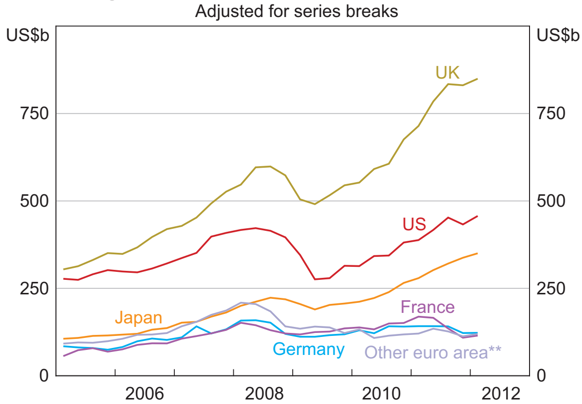
NPL ratios have also fallen for the large UK banks recently, but less so than in the United States, consistent with weaker conditions in the economies where they are most active (Graph 1.19). In response to concerns about the availability of credit and a weak domestic economy, the UK authorities introduced a 'Funding for Lending Scheme' that provides public sector supported financing for banks that expand their lending to the real economy. It is not yet clear to what extent the reduction in bank funding costs under this Scheme (in the order of 1–2 percentage points) will boost lending.

Banks in other advanced countries have experienced stronger asset quality in recent years, though in some countries they are facing a different set of challenges associated with property market expansions. In Canada, low interest rates and strong mortgage competition over the past few years have contributed to buoyant housing construction activity and strong growth in property prices and household debt. This has given rise to concerns about housing market overvaluation and the potential for a correction in prices. In response, the authorities have been progressively tightening lending standards, such as by lowering permissible loan-to-valuation ratios (LVRs) and loan terms on housing loans insured by the government mortgage insurer. Switzerland is facing some similar issues, with the authorities there recently deciding to increase risk weights on high-LVR housing loans from 2013, much as the Australian Prudential Regulation Authority did in Australia in 2004.

Banking Systems in the Asian Region

Some euro area banks have responded to balance sheet pressures by scaling back their presence in Asia. French banks, in particular, cut US dollar assets globally as US dollar funding became harder to obtain. Euro area banks' total claims on non-Japan Asia fell by more than 20 per cent over the second half of 2011 (Graph 1.22). The decline was most noticeable in the trade finance and longer-term specialised lending markets (such as aircraft, project and shipping finance), but conditions in these markets appear to have improved in 2012. More generally, euro area banks' claims on non-Japan Asia rose modestly over the March quarter 2012 (the latest available data), and bank claims data and other reports suggest that banks from elsewhere have been filling some of the gap, including large banks from emerging Asia, Australia, Japan and the United Kingdom. Some of these banks, particularly those from Japan, may have been attracted by stronger longer-term growth and profit opportunities than

Graph 1.22
Foreign Banks' Claims on Non-Japan Asia*
Adjusted for series breaks



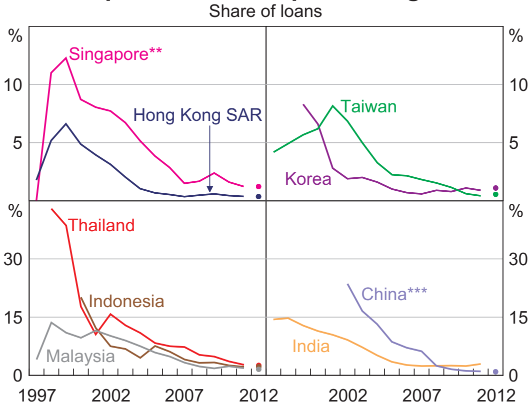
* Consolidated claims of reporting banks on an immediate borrower basis; non-Japan Asia is comprised of China, Hong Kong SAR, India, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand
** Includes Belgium, Greece, Italy, Netherlands, Portugal, Spain
Sources: BIS; RBA

those available in their home markets. They might also have been taking advantage of higher US dollar funding as investors have cut back their lending to euro area banks. However, the diversification and other benefits from cross-border lending must be weighed against the resultant funding, credit and operational risks.

Putting these shifts in perspective, though, euro area banks account for only a small share of credit in Asia, and local Asian banks have little direct exposure to Europe. Asian banking systems have therefore been resilient to the turmoil in the euro area, and the local banks' limited usage of wholesale funding has largely insulated them from volatility in global funding markets. Their profitability has also generally been robust over recent years and NPL ratios have declined to historically low levels (Graph 1.23). The question is whether these trends have been flattered by strong growth in domestic credit and nominal incomes in the region.

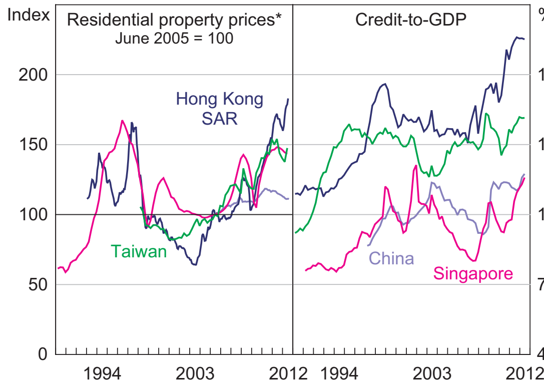
Property prices have also risen significantly in a few economies, especially where exchange rate regimes have limited the scope to raise interest rates, prompting authorities to introduce a range of other measures over recent years to cool their property markets (Graph 1.24). If property prices were to

Graph 1.23
Non-Japan Asia – Non-performing Loans*
Share of loans



* Definitions of 'non-performing' differ across jurisdictions; dots are June quarter estimates with the exception of Korea where estimate is for the March quarter
** Domestic banks only
*** Data for 2002–2004 are for major commercial banks only
Sources: CEIC; RBA; banks' annual reports; national banking regulators

Graph 1.24
Asset Prices and Credit



* Adjusted for inflation; for China, data are an average of new and existing residential property prices
Sources: CEIC; RBA; central banks

unwind, or global growth – and thus export sector revenue – were to slow substantially, Asian banks could encounter some credit quality problems. That said, capital buffers have increased over recent years to fairly high levels, which should help banks cope with any slowing in economic activity and associated rise in problem loans. The authorities in most of these countries also generally have room to ease macroeconomic policies if necessary.

Slowing economic activity in India over the past year has contributed to an increase in banks' NPL ratios and slower profit growth, especially for some state-owned banks. There has also been a sharp increase in the share of Indian banks' loans that have been restructured to assist troubled borrowers. In China, the banks' aggregate NPL ratio remains at a low level of about 1 per cent, but there are signs that bank asset performance has begun to deteriorate this year as the pace of economic activity has moderated.[2] Some large Chinese commercial banks have reported a pick-up in their NPL ratios for specific industries or regions, while a number of smaller commercial banks have recorded increases in their overall NPL ratios. There have also been reports of repayment difficulties in parts of the

2 For information on trends in Chinese banks' asset performance over the past couple of decades, see Turner G, N Tan and D Sadeghian (2012), 'The Chinese Banking System', RBA *Bulletin*, September, pp 53–63.

private (non-bank) lending sector, which mainly services relatively small and higher-risk business borrowers. While the direct links between these lenders and the banking sector are not large, there could be indirect links and their experience may signal a broader deterioration in asset quality in the Chinese financial system that a growing number of commentators are now predicting. Investor concerns over Chinese banks' asset quality are reflected in significant declines in their share prices over the past six months.

Concerns about the effects of slowing economic activity have already prompted Chinese policymakers to ease fiscal and monetary settings this year. They have also taken a number of prudential and other measures to support lending growth, including: delaying the introduction of Basel III capital standards by one year to the start of 2013, to be in line with the international timetable; and granting banks greater ability to price loans below benchmark lending rates set by the People's Bank of China.[3] Banks have also been encouraged to ensure that growth in lending to small businesses is maintained at a pace that is at, or above, total credit growth. To facilitate lending to small businesses, the China Banking Regulatory Commission has reduced the risk weighting on small business loans and allowed certain small business loans to be excluded from regulatory loan-to-deposit ratio calculations. Because lending to small businesses currently represents a relatively small share of Chinese banks' total lending, an increase in this type of lending could reduce concentrations in banks' loan portfolios, as well as support economic activity, though the risks of such loans will also need to be carefully managed. ✠

3 The larger allowable discount on Chinese banks' loan rates is part of a broader move towards greater interest rate flexibility in China; all bank deposit rates are now permitted to be set up to 10 per cent above the relevant benchmark rates.