# Overview

The euro area sovereign debt and banking crisis has continued to weigh on global financial conditions in the period since the previous *Financial Stability Review*. Although fears of a liquidity crisis in the euro area were generally assuaged earlier in the year following the European Central Bank's (ECB's) large-scale lending to banks, concerns about the resilience of sovereign and bank balance sheets in the region have persisted. Developments in Greece and Spain, in particular, triggered a renewed bout of risk aversion and market volatility between April and July, as markets became less confident that these and other euro area countries could return their fiscal positions to more sustainable paths. Sovereign borrowing costs and risk premiums rose to record levels in some euro area countries and global share prices declined. These events added to broader doubts about the viability of the monetary union, spurring investors to move capital out of the most troubled countries to avoid redenomination risk should they exit the euro. This put further funding strain on banks in the region, many of which have been under pressure for some time given the deteriorating economic conditions in the euro area and their exposures to sovereigns with weak fiscal positions.

Since August, there has been a noticeable improvement in market sentiment and risk pricing in the euro area. This mainly reflected the ECB's announcement of a sovereign bond purchase program, known as Outright Monetary Transactions. European authorities also recently announced plans to more closely integrate the region's financial regulatory structure, including by centralising bank supervision under the ECB; in addition, there has been further progress towards the establishment of the expanded and permanent European bailout mechanism. Despite these steps, some of the longer-term policy measures involve significant implementation risk, and many of the underlying problems in the euro area are yet to be effectively resolved. Fiscal deficits remain large; many banks need to repair their balance sheets further; and the adverse feedback loop between sovereign and bank finances has yet to be broken. Given these ongoing difficulties, markets will likely remain sensitive to any setbacks in dealing with the euro area crisis. Along with the weaker near-term outlook for global growth, the euro area problems will continue to pose heightened risks to global financial stability in the period ahead.

Outside the euro area, the major advanced country banking systems have generally continued on a gradual path to recovery in recent quarters. However, sentiment towards them has also been held back by the risk of a disorderly resolution to the European problems and softer economic indicators in some of the largest economies, including the United States and China. While asset quality measures have generally improved, underlying profitability of the major banking systems remains subdued. Weak property market conditions and the financial market and regulatory pressures on certain bank business models are continuing to weigh on the outlook for many large banks.

Asian banking systems have largely been resilient to the euro area problems, partly because of their domestic focus. While non-performing loan ratios are generally low, vulnerabilities may have built up during recent credit expansions, which could be revealed in the event of a significant decline in asset prices or economic activity. As some banking systems in Asia are now quite large, there is a greater chance that problems in them could have adverse international spillovers.

Against this backdrop, the Australian banking system has remained in a relatively strong position. Pressures in wholesale funding markets have eased since late last year, allowing the large banks to maintain good access to international bond markets during the past six months. Banks' bond spreads have narrowed, and are now comparable to levels in mid 2011, prior to the escalation of the euro area debt problems. This has enabled the banks to issue a larger share of their bonds in unsecured form than they did at the beginning of the year when tensions in global funding markets were high. Even so, banks have reduced their relative use of wholesale funding further as growth in deposits has continued to outpace growth in credit. While the Australian banks have little direct asset exposure to the most troubled euro area countries, they remain exposed to swings in global financial market sentiment associated with the problems in Europe. They should be more resilient to such episodes though, given the improvements they have made to their funding, liquidity and capital positions over recent years. Around half of the banks' funding now comes from customer deposits, which is a broadly similar share to a number of other comparable countries' banking systems.

The Australian banks' asset performance has improved a little over the past six months, but the aggregate non-performing loan ratio is still higher than it was prior to the crisis, mainly reflecting some poorly performing commercial property loans and difficult conditions being experienced in some other parts of the business sector. In aggregate, the banks' bad and doubtful debt charges have declined more substantially since the peak of the crisis period. However, they now appear to have troughed, which has contributed – along with higher funding costs and lower credit growth – to a slower rate of profit growth in recent reporting periods. While this has prompted a renewed focus by banks on cost containment, at this stage, it has not spurred inappropriate risk-taking. With demand for credit likely to remain moderate, a challenge for firms in a competitive banking environment will be to resist the pressure to ease lending standards to gain market share in the pursuit of unrealistic profit expectations.

The household and business sectors have continued to display a relatively prudent approach towards their finances in recent quarters. Many households continue to prefer saving and paying down their existing debt more quickly than required, which has contributed to household credit growth being more in line with income growth in recent years. Although there are some isolated pockets of weakness, aggregate measures of financial stress remain low. Ongoing consolidation of household balance sheets would be desirable from a financial stability perspective, as it would make indebted households better able to cope with any future income shock or fall in housing prices.

After a period of deleveraging, there has recently been a pick-up in business borrowing, though businesses' overall recourse to external funding remains below average. While the uneven conditions in the business sector have been contributing to the weaker performance in banks' loan portfolios in recent years, business balance sheets are in good shape overall. Aggregate profit growth of the non-financial business sector has moderated recently, but profits remain around average as a share of GDP.

Managing the risks posed by systemically important financial institutions (SIFIs) continues to be a focus of the international regulatory reform agenda. A principles-based policy framework for domestic systemically important banks (so-called D-SIBs) is close to being finalised, complementing the framework for dealing with global SIBs agreed last year. Work to strengthen resolution regimes for global SIFIs and extend the SIFI framework to non-bank financial institutions is also underway. Progress has also been made both globally and domestically on several other initiatives, including reforms to the regulation of financial market infrastructures and over-the-counter derivatives. Domestically, the Australian Prudential Regulation Authority has been continuing the process of implementing the Basel III bank capital and liquidity reforms in Australia, as well as finalising reforms to the regulatory capital framework for insurers and introducing prudential standards for superannuation funds. As noted in the previous *Review*, Australia has this year undergone an IMF Financial Sector Assessment Program review. The results, which are due to be published later this year, confirm that Australia has a stable financial system, with robust financial regulatory, supervisory and crisis management frameworks.