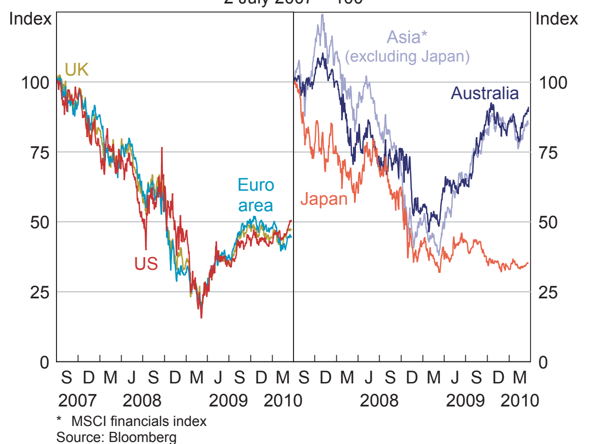
The Global Financial Environment

Sentiment towards banks has improved markedly since the turmoil of late 2008 and early 2009. While market-based indicators of risk in the financial sector generally remain above pre-crisis levels, many banking systems have returned to profitability, and capital and funding positions have been bolstered. Public sector support arrangements for the financial sector have been wound back in a number of countries.

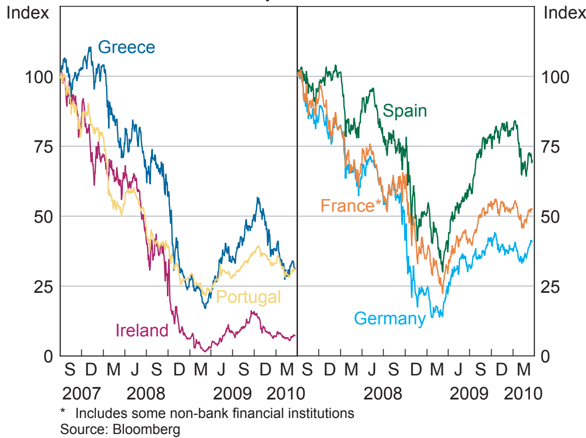
Confidence, however, remains fragile. A particular concern, focused on Europe, is the effect of the build-up in government debt on sovereign credit risk and the potential for contagion to other funding markets. More generally, investors are wary about the resilience of economic and financial conditions to the withdrawal of the extraordinary stimulus policies that supported the recovery. An ongoing concern is the interplay between the financial sector and the real economy, as in many countries credit supply remains tight and loan losses continue to weigh on bank profits.

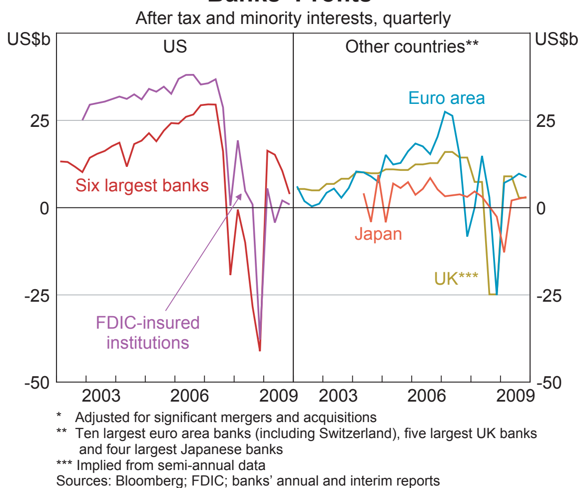
Profitability and Capital

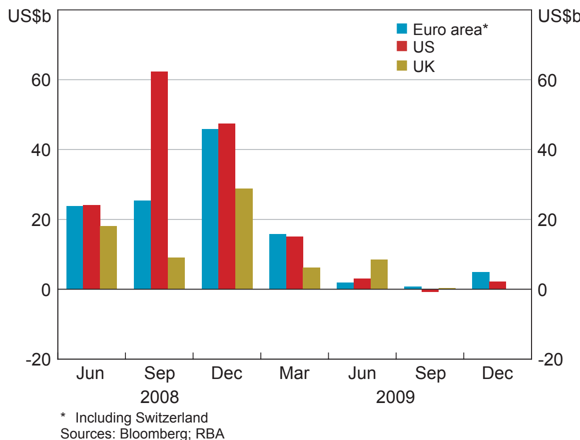
Confidence in the global banking system over the past six months has been relatively steady overall, when compared with the swings between panic and relief seen in the preceding twelve months. The sharp recovery in many bank share prices between March and September 2009 has been broadly maintained in most countries, with Japanese banks an exception (Graph 1). There remains large dispersion by region, consistent with differing macroeconomic outcomes. In the United States, the euro area, the United Kingdom and Japan, banking sector share price indices are 50 per cent or more below mid-2007 levels, whereas in Australia and Asia (excluding Japan) prices are less than 20 per cent below. Japanese bank share prices have also been relatively more affected by investor concerns about the possible impact of regulatory changes aimed at increasing the quality of bank capital.



The softer tone evident in recent months for some euro area bank share prices has reflected concerns in sovereign debt markets in some parts of Europe, particularly Greece (Graph 2). A large near-term debt refinancing need has focused attention on the size of Greek fiscal debt, and this in turn has affected confidence in the stability of the euro, and in some European debt markets (discussed further below in the section on wholesale funding markets and credit). European banks have the greatest exposures to Greece, although these are generally a small share of their overall assets.







The broad recovery in sentiment towards banking systems in most major countries since early 2009 has reflected their general return to profitability. For a sample of large banks in the United States, euro area, the United Kingdom and Japan, aggregate profits have been recorded recently, after heavy prior losses (Graph 3). Nonetheless, the latest profit results are generally modest by the standards of preceding years and within these samples some banks continued to report losses. Industry-wide data from the United States show that larger banks have recently tended to perform better than their smaller counterparts. The level of profits for all Federal Deposit Insurance Corporation (FDIC) insured institutions was barely positive over 2009; around one third of institutions were unprofitable in the December quarter and 78 failed in the six months to end February 2010, compared to 68 over the preceding six months.

Bank profits, particularly for larger banks, have been supported by easier financial conditions. Interest margins have generally increased since 2008 for larger banks, consistent with historically steep yield curves in the major markets, better funding conditions and banks being able to charge higher risk premiums for loans. For the typically larger banks with investment banking operations, market conditions have aided profits in 2009 with high volatility boosting trading returns and widening bid-ask spreads, and a pick-up in underwriting income coming from debt and equity raising activity. The firmer tone in securities markets has helped to limit securities write-downs, following those of 2008 that were so damaging for the larger banks (Graph 4).

Economic conditions, however, continue to weigh on bank performance through the lagged effect on loan-loss provisions (Graph 5). In the United States, provisions amount to over 3 per cent of loans, more than double the level seen in the early 1990s. Nonetheless, this measure has shown signs of stabilisation in recent quarters, and in the other major markets the trajectory of the rise has flattened

in the most recent data. Bankers and regulators alike have been reluctant to predict the future drag on profits from provisions: that will ultimately depend on outcomes for the economy and asset prices, the quality of prior lending decisions, and the adequacy of reserves already built up. Reserves for a sample of large European banks are notably lower than their counterparts in the United States and the United Kingdom; that said, European property markets have generally not suffered the same price falls seen in these countries, and the rise in unemployment has generally been less pronounced (as discussed below in the section on loan quality and asset prices).

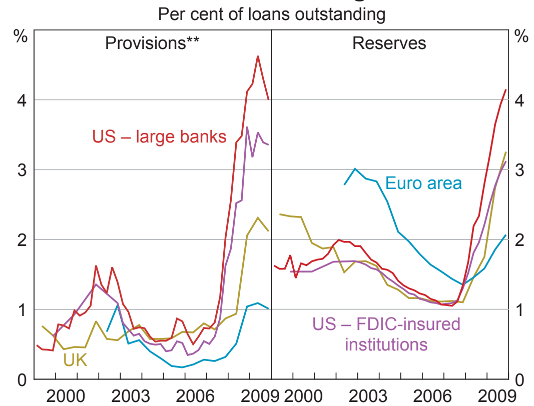
While it was the larger banks that were mainly affected by securities losses, poor loan performance is a greater concern for the smaller banks. In the United States, small-to-medium sized banks, which together account for a little under half of the assets of US banks, have around 10 to 15 percentage points more of their assets in loans than larger banks (Graph 6). They also have a higher concentration in loans linked to real estate, particularly commercial property, where conditions remain very difficult.

Banks are continuing to strengthen their balance sheets by raising capital, restraining dividends and selling non-core assets. The need for government capital has diminished, as private markets have become more willing to participate in equity raisings and, in a number of cases, government capital support arrangements have been withdrawn (Graph 7). Under the US TARP, of the US$200 billion used under the Capital Purchase Program, over US$130 billion has been repaid, though mostly by the largest institutions; some smaller banks were still applying for capital injections up until the closing date in late 2009. In Europe, a number of large financial institutions have also repaid their government capital injections. A number of institutions in Europe have issued, or announced an intention to issue, contingent capital securities, instruments designed to top-up an

Graph 5

Banks' Loan Loss Provisioning and Reserves*

Per cent of loans outstanding



* Six largest US banks, five largest UK banks and six largest euro area banks (including Switzerland) for which data are available; adjusted for significant mergers and acquisitions

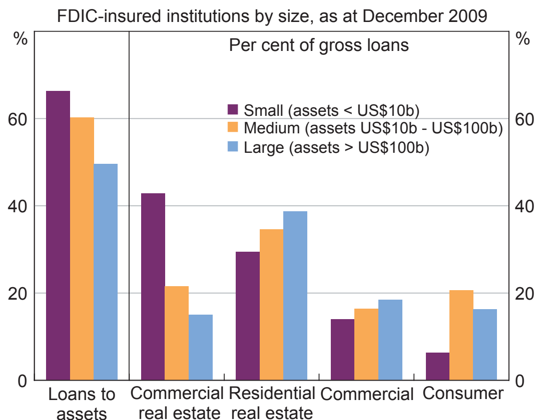
** Annualised values of quarterly (US, FDIC and Europe) or semi-annual (UK) provisions; not seasonally adjusted

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

Graph 6

US Banks' Loans

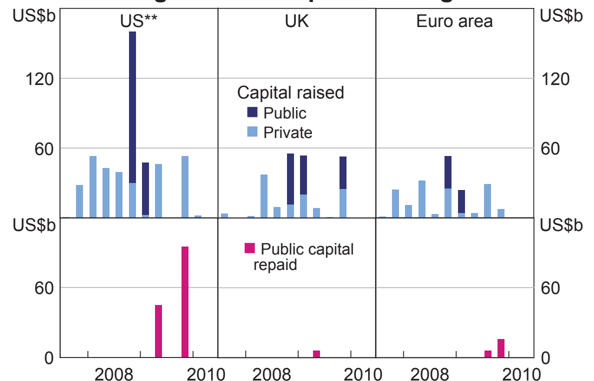
FDIC-insured institutions by size, as at December 2009



Source: FDIC

Graph 7

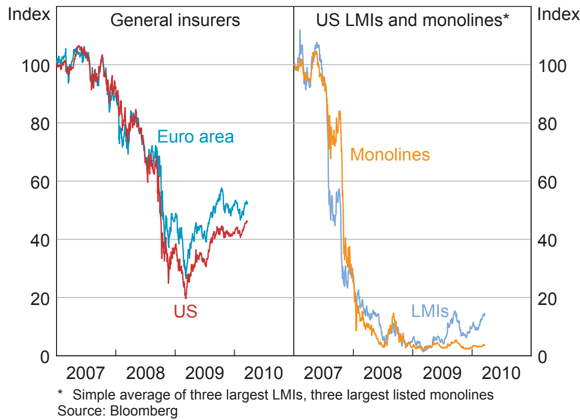
Large Banks' Capital Raisings*

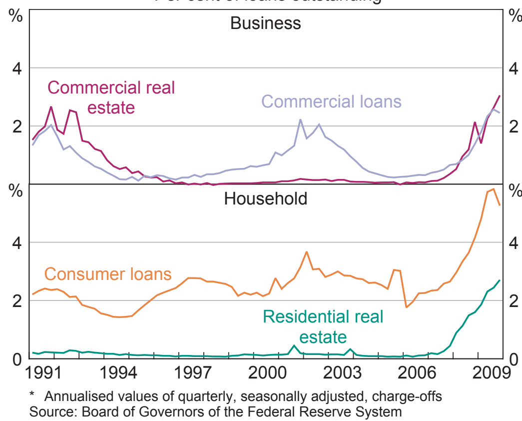


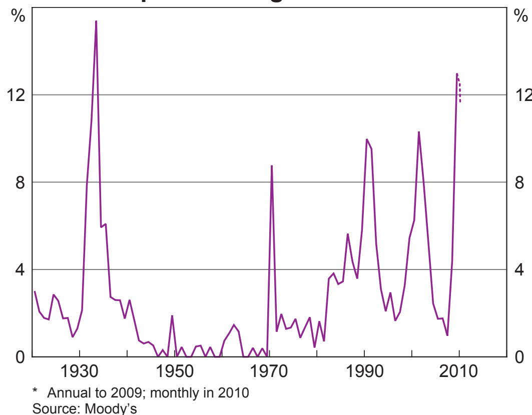
* Six largest US banks, five largest UK banks and ten largest euro area banks (including Switzerland); adjusted for significant mergers and acquisitions

** March quarter 2010 is quarter to date

Sources: Bloomberg; US Treasury; banks' annual and interim reports and press releases







institution's capital ratio should it breach a pre-set trigger point.

Profits of large general insurers in the US and the euro area have shown a similar pattern to banks, returning to modest profitability in 2009 after large asset-related losses in 2008. Share price movements for these insurers have also mirrored the general trend for banks, remaining relatively steady for the past six months after the strong recovery from early 2009 (Graph 8). Reinsurers' profitability has also risen, with increased underwriting as primary insurers look to lower their risk profile. A number of areas in the insurance industry, however, remain severely weakened. US lenders' mortgage insurers (LMIs) generally continued to report losses in 2009, weighed down by claims arising from mortgage defaults and low rates of new business. Large monoline insurers also generally recorded losses over 2009, reflecting their exposures to US residential mortgage-backed securities and related collateralised debt obligations.

Loan Quality and Asset Prices

Loan quality remains a concern in many major economies, given the depth of the downturn in activity and asset prices, questions over the strength and durability of the recovery, and the usual lags between economic downturns and problem loans. In contrast, for many – particularly emerging – countries, concerns are more focused on buoyant asset markets and their possible implications for future loan quality.

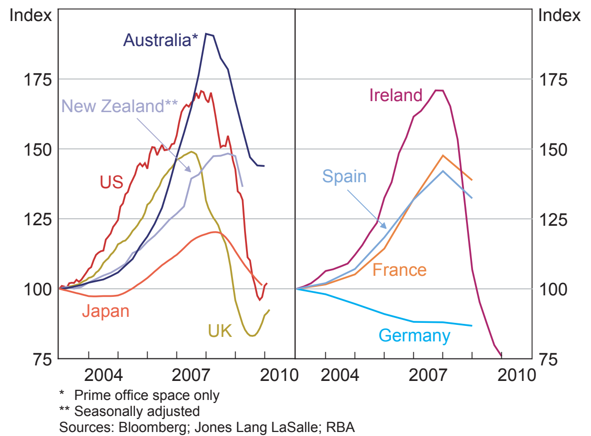
In the United States, a feature of the recent cycle has been the broad-based deterioration in loan quality. The rise in charge-offs for business loans has been similar to recent downturns, but charge-offs for household loans are well above the peaks of the past 20 years (Graph 9). In the December quarter 2009, charge-offs on loans for real estate – both commercial and residential – increased further. In the euro area and United Kingdom, loan losses also increased over 2009, mostly reflecting business loans (including commercial property).

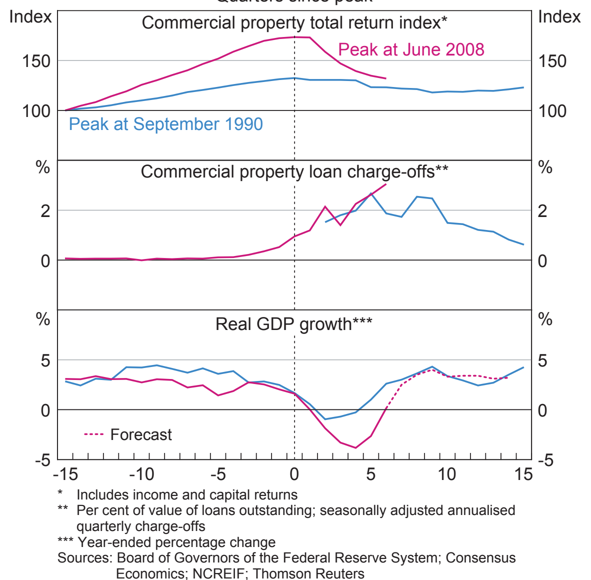
An indication of the pressure on business loan exposures is that, in late 2009, the global default rate on corporate speculative-grade debt rose above the peaks of recent downturns, to reach its highest level since the 1930s (Graph 10). A feature of many recent corporate defaults has been low recovery rates for creditors, partly reflecting the easy terms on which the debt had been made available (see *Box A: Global Recovery Rates on Corporate Defaults*). Nonetheless, there are some early signs that the default rate may have peaked, reflecting the general improvement in macroeconomic and financial conditions.

The quality of commercial property loans in a number of countries continues to be affected by large falls in collateral values. Commercial property prices in the United States and the United Kingdom are around 40 per cent below their peaks, reflecting high vacancy rates and difficult financing conditions (Graph 11). These declines are much steeper than in large euro area countries. The most recent commercial property price data available point to some early signs of recovery: in the United States, prices have risen by 6 per cent over the three months to January 2010, and in the United Kingdom prices have risen by 11 per cent since the trough.

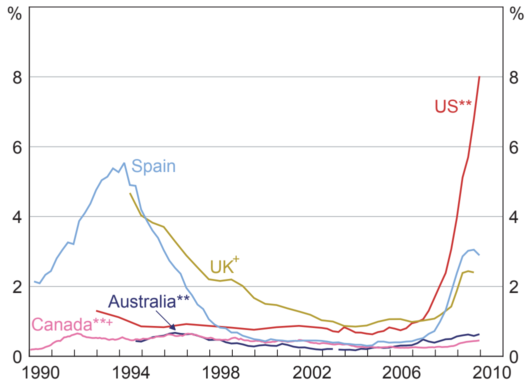
Price falls of the magnitude seen over the past couple of years are likely to continue to underpin write-offs in the period ahead. In the United States, in the previous cycle in the 1990s, commercial property charge-offs remained high for a number of years after the peak in prices. In the current cycle, charge-offs are already above the previous peak, and the current cycle in commercial property prices and GDP growth is more severe (Graph 12).

The quality of residential real estate loans also remains under pressure, particularly in the United States. Despite residential real estate write-offs already being historically high in the United States, the share of non-performing housing loans on US bank balance sheets rose further in December 2009, to 8 per cent, well above



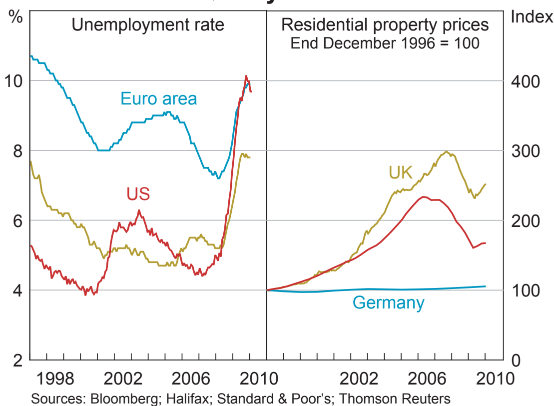


Graph 13
Non-performing Housing Loans
Per cent of loans*



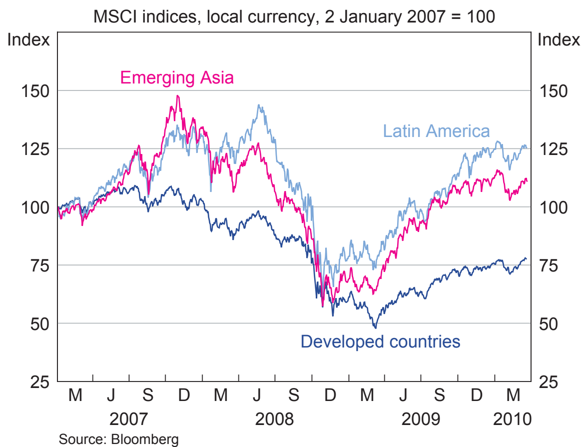
* Per cent of loans by value. Includes 'impaired' loans unless otherwise stated. For Australia, only includes loans 90+ days in arrears prior to September 2003.
** Banks only.
+ Per cent of loans by number that are 90+ days in arrears.
Sources: APRA; Bank of Spain; Canadian Bankers' Association; Council of Mortgage Lenders; FDIC; RBA

Graph 14
Loan Quality Indicators



Sources: Bloomberg; Halifax; Standard & Poor's; Thomson Reuters

Graph 15
Share Price Indices
MSCI indices, local currency, 2 January 2007 = 100



Source: Bloomberg

comparable data for other countries (Graph 13). The US Government and lenders have attempted to assist households in payment arrears by establishing programs under which loan terms can be amended, but many participants have subsequently lapsed back into arrears. Loan quality remains particularly poor on sub-prime mortgages, with around one quarter of such mortgages more than 30 days in arrears, but prime loans, whether on lenders' balance sheets or securitised, are also showing historically high arrears rates. Non-performing loans are also high in the United Kingdom and Spain, though there are some signs of stabilisation in the most recent observations.

Differences in housing loan quality across countries have been influenced by labour market conditions and housing prices, although earlier variations in lending standards have also played a crucial role. Of the major economies, the United States has had both the sharpest rise in unemployment rates (currently around 5 percentage points above the trough) and the steepest fall in house prices (currently almost 30 per cent below the peak on one measure) (Graph 14). In recent months there have been some modest improvements in these drivers of housing loan quality in a number of countries. Unemployment is off the October 2009 peak in the United States and, by late 2009, house prices in the United States and the United Kingdom had risen by 4 and 9 per cent respectively from their troughs.

While large asset price declines are a current concern in a number of countries, in others the focus is on the potential for buoyant asset markets to be a cause of future problems. This reflects the wide variation in macroeconomic conditions, and the accommodating financial conditions that generally continue to prevail, even in countries where growth has been robust.

These concerns are relevant for a number of emerging countries. One indication of the shift in financial conditions they have experienced is the sharp turnaround in capital flows: net portfolio inflows to emerging markets were around US$70 billion in 2009 compared with net outflows of around US$60 billion in 2008. Consistent with this, share price indices in

emerging Asia and Latin America have risen strongly, and significantly outperformed those in developed countries (Graph 15). In China, credit growth in the year to February 2010 was above average at 27 per cent, though it has slowed in recent months. The People's Bank of China has raised the reserve requirement ratio for large banks on two occasions early in 2010, noting expectations of higher inflation.

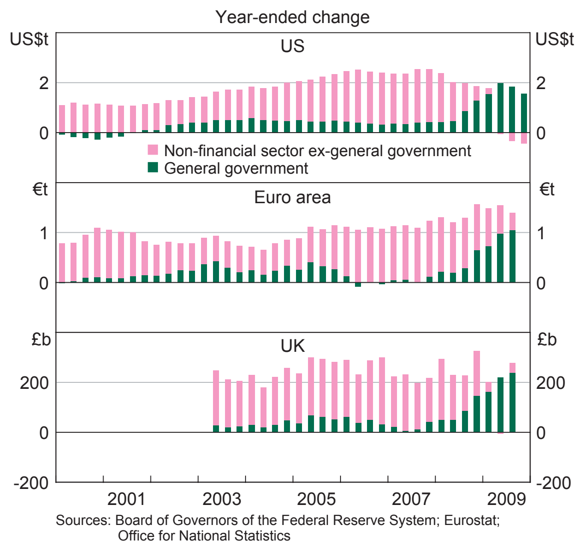
Concerns about buoyant financial conditions have not, however, been restricted to emerging countries: a number of industrialised countries have announced measures prompted by concerns about housing market developments. In February 2010, the Canadian Government announced new restrictions, including a reduction in loan-to-valuation ratios (LVRs), for some types of residential mortgages to be eligible for insurance by the government-owned mortgage insurer. Also in February, the Swedish financial regulator recommended limiting LVRs on new mortgage lending.

Wholesale Funding Markets and Credit

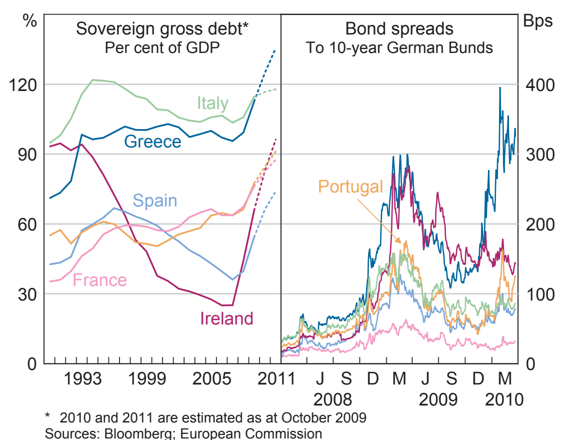
The recovery in economies and financial markets has received significant assistance from policy actions to stimulate economies and support financial sectors. One indication of the marked easing in fiscal policy is that, over the past year, while households and businesses in the United States, the euro area and the United Kingdom have largely stopped borrowing in net terms, the effect of this on the flow of new debt has been broadly offset by increased borrowing by governments (Graph 16).

The degree of fiscal expansion raises broad questions about the resilience of economies to its eventual withdrawal, and the potential for longer-term crowding out of private sector borrowing if government deficits remain high. For some investors, a more immediate concern in recent months has been the sustainability of public finances for some countries. That these concerns are particularly focused on Greece reflects that it has a high ratio of public debt to GDP, a large budget deficit, and that it needs to roll-over a large amount of debt this year, with a significant amount falling due in April and May. There have also been some doubts about the accuracy of government finance figures. The heightened concern of investors has been reflected in wider spreads on Greek sovereign bonds, though yields are still low in absolute terms. Recently these spreads have narrowed somewhat from their peak, following announced actions by the Greek Government to improve its finances, and speculation about European Union financial support (Graph 17).

Graph 16
Domestic Non-financial Debt Flows



Graph 17
Euro Area Government Debt Indicators



This environment presents a difficult challenge for policymakers. In the euro area, policy flexibility for any individual country to handle fiscal adjustment is limited by the common currency and there is unease that the strains associated with Greece could flow onto other countries in the euro area with high debt and also to the euro itself. Such contagion is the broader financial stability concern, as the amounts involved with Greece are not large in a global context: foreign banking sector claims on Greece typically amount to less than 1 per cent of their total assets, with the bulk of funds sourced from European banks (Table 1). European banks are also the main funders of other European countries where government debt levels have been a recent market focus.

Another policy-related consideration for financial markets is the potential effect of the eventual withdrawal of the current, very accommodative, monetary policy stance. While the major central banks have flagged that low interest rates will be maintained for some time, recent significant central bank net purchases of securities under quantitative easing policies are drawing to a close; the Bank of England has already achieved its target level of purchases and the US Federal Reserve has flagged that it will achieve its target by the end of March 2010. Central bank balance sheets in the United States, euro area and the United Kingdom remain significantly larger than their pre-crisis levels, though some liquidity support measures have already been wound back

Table 1: Foreign Bank Claims on Euro Area Countries[(a)]
Ultimate risk basis, as at 30 September 2009, per cent of lending country's total bank assets[(b)]

Reporting banks (by headquarter location)	Greece	Ireland	Italy	Portugal	Spain	Subtotal	Euro area
Euro area banks	0.4	0.8	2.1	0.5	1.5	5.3	12.4
of which:							
German	*0.4*	*1.8*	*1.9*	*0.4*	*2.2*	*6.7*	*13.4*
French	*0.7*	*0.6*	*4.3*	*0.3*	*1.6*	*7.6*	*13.8*
Dutch	*0.4*	*1.0*	*2.3*	*0.4*	*3.9*	*8.0*	*22.6*
Belgian	*0.5*	*2.5*	*3.1*	*0.7*	*2.8*	*9.5*	*27.0*
Spanish	*0.0*	*0.3*	*1.0*	*1.7*	–	*3.1*	*6.2*
Portuguese	*1.4*	*0.7*	*0.8*	–	*4.1*	*6.9*	*11.7*
Swiss banks	2.6	0.6	0.9	0.1	0.6	4.9	16.2
UK banks	0.1	1.8	0.8	0.2	1.1	4.0	10.2
US banks	0.1	0.4	0.4	0.0	0.4	1.3	4.3
Japanese banks	0.1	0.2	0.6	0.0	0.3	1.2	5.6
Australian banks	0.0	0.1	0.5	0.0	0.1	0.7	2.2

(a) Based on 24 countries reporting to the BIS
(b) Monetary financial institutions used as a proxy for total bank assets for countries in the euro area
Sources: BIS; RBA; Thomson Reuters; central banks

(Graph 18). The US Federal Reserve has developed a range of tools to assist in the process of removing policy accommodation, including establishing the ability to pay interest on bank reserves, engage in reverse repurchase agreements and offer term deposits.

Bank funding markets in the major countries have generally been resilient to the recent focus on sovereign risk. Over the past six months, spreads have fallen further in all major short-term interbank funding markets, and spreads on long-term bank debt have also narrowed (Graph 19). These developments have encouraged banks to make use of normal funding arrangements, and to reduce their use of government support measures, such as central bank liquidity support and government guarantees on bank debt.

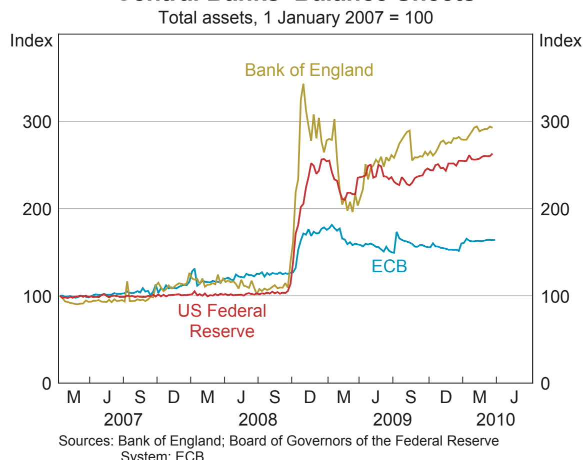
Reflecting the better conditions, a number of countries have closed – or announced an imminent closure of – their bank wholesale funding guarantee schemes to new borrowing (Table 2).

Table 2: Announced Final Date for Guaranteed Issuance[a]

Country	Date
United States	31-Oct-09
Canada	31-Dec-09
France	31-Dec-09
Korea	31-Dec-09
United Kingdom	28-Feb-10
Australia	31-Mar-10
New Zealand	30-Apr-10
Sweden	30-Apr-10
Ireland[b]	01-Jun-10
Denmark[b]	30-Jun-10
Finland	30-Jun-10
Germany[b]	30-Jun-10
Netherlands	30-Jun-10
Spain[c]	Jun-10
Belgium	31-Oct-10

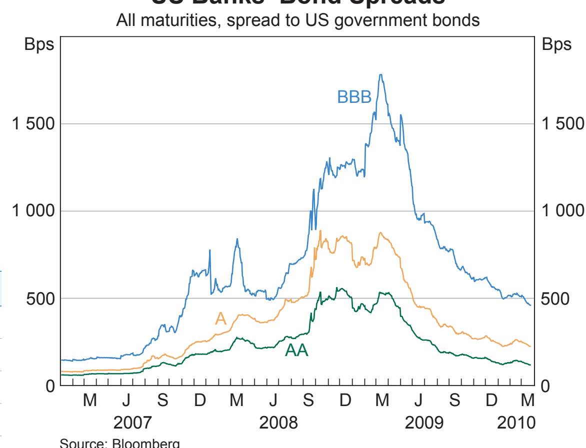
(a) Selected countries.
(b) Legislation for schemes in Denmark and Germany set until 31 December 2010 and in Ireland until 29 September 2010, but EC approval required for further extensions every six months.
(c) Exact final date unconfirmed.
Sources: BIS; central banks; debt management offices and guarantee administrators; treasury departments.

Graph 18
Central Banks' Balance Sheets
Total assets, 1 January 2007 = 100



Sources: Bank of England; Board of Governors of the Federal Reserve System; ECB

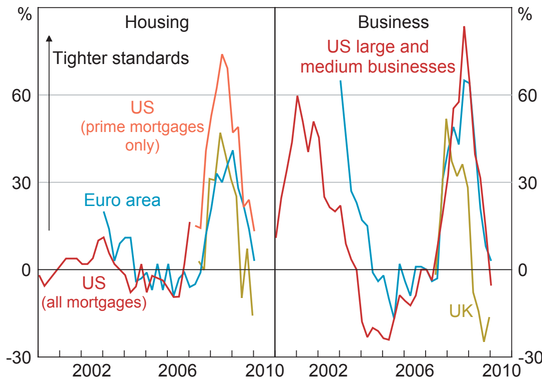
Graph 19
US Banks' Bond Spreads
All maturities, spread to US government bonds



Source: Bloomberg

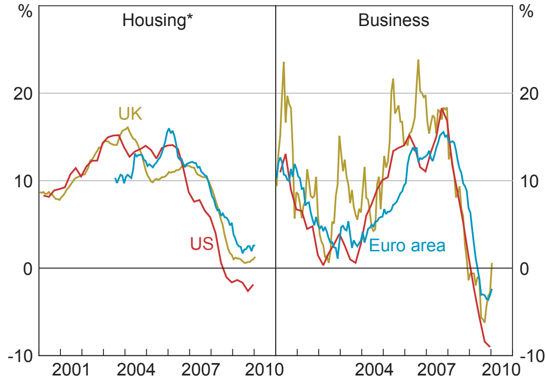
In contrast, in December 2009 a number of countries in Europe gained European Commission approval to extend their schemes past the previously announced closure date. Around this time, the ECB noted that many European banks have a significant amount of debt maturities in the next two years and that, at least for some institutions, the improved outlook may remain partly reliant on existing support arrangements. Other support arrangements for European bank funding also remain in place, such as the ECB's covered bond purchase program under which the ECB has purchased over €40 billion of the €60 billion allocated towards the program.

Graph 20
Credit Standards*



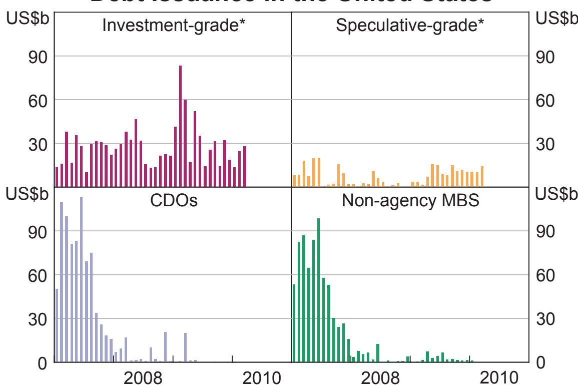
* Net percentage reporting tightening standards. US and Europe ask whether *lending standards* have changed. UK asks whether the *supply of credit* has changed. UK applies twice the weight to a 'considerably' answer relative to a 'somewhat' answer. US and Europe apply an equal weight.
Sources: Bank of England; Board of Governors of the Federal Reserve System; ECB

Graph 21
Intermediated Credit Growth
Six-month-ended annualised percentage change, seasonally adjusted



* Euro area data adjusted by the RBA for securitisations
Sources: Bank of England; Board of Governors of the Federal Reserve System; ECB; RBA

Graph 22
Debt Issuance in the United States



* Non-financial corporate issuance; March 2010 is month to date
Sources: JPMorgan; SIFMA; Thomson Reuters

Despite funding conditions for banks having improved significantly since the crisis, banks in the major advanced countries remain cautious and credit supply weak. Loan officer surveys generally show that credit standards remain tight in the major countries although they have eased somewhat in recent months (Graph 20).

But these surveys also show that credit demand is subdued, particularly among businesses, reflecting their desire to reduce leverage, access to alternative sources of funding and reduced ability to borrow given the weakness in collateral values.

Reflecting these demand and supply conditions, business credit growth remained negative over the six months to December 2009 in the United States, the euro area and the United Kingdom, although the pace of contraction appears to be slowing (Graph 21). Housing credit growth has not fallen as sharply, but it remains quite weak. In the United States, housing credit declined over the six months to December although, as in the euro area and the United Kingdom, the downturn in housing finance appears to be stabilising.

Capital market funding, an alternative to bank credit for larger corporate borrowers, also remains relatively subdued. Investment-grade corporate bond issuance remains at levels similar to mid 2009 (Graph 22). Speculative-grade debt issuance has been reasonably solid over 2009, though this appears to have been primarily for refinancing purposes. Issuance of more complex structured credit products such as collateralised debt obligations (CDOs), non-agency mortgage-backed securities (MBS) and commercial MBS (CMBS) remains negligible and generally only possible where there is official-sector support. Debt to finance riskier transactions such as leveraged buy-outs (LBOs) remains difficult to obtain, although merger and acquisition activity is showing signs of picking up (Graph 23).

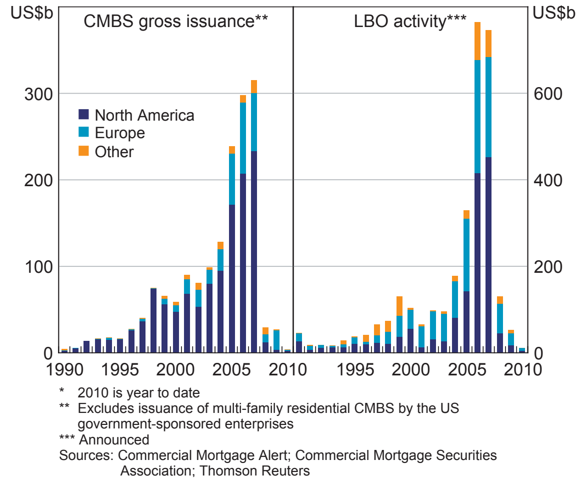
In contrast to subdued borrowing, corporates have been actively raising equity, particularly in the second half of 2009 (Graph 24). The pick-up in equity issuance has been primarily undertaken by existing firms, with initial public offerings (IPOs) still relatively subdued, though recovering. Much of the equity raised by firms has been used to pay back debt or otherwise bolster balance sheets.

Overall, the actions of banks, businesses and households are all consistent with a gradual improvement in financial conditions overlaid with an ongoing cautious approach to risk in the wake of the financial crisis. This aversion to debt is hardly surprising, given the shocks they have experienced to the terms and availability of funding, to cashflows available to service debt, and to asset values. Moreover, there are considerable challenges ahead, as the exit from highly stimulatory fiscal and monetary policies, and the attendant impact on growth, inflation, government finances and funding markets will need to be carefully managed.

Graph 23

Global Market Activity*

Annual

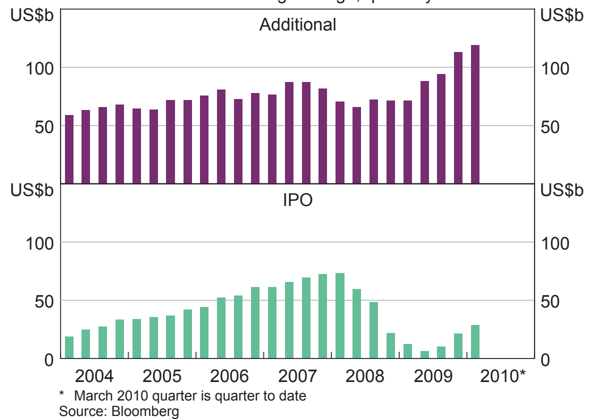


* 2010 is year to date
** Excludes issuance of multi-family residential CMBS by the US government-sponsored enterprises
*** Announced
Sources: Commercial Mortgage Alert; Commercial Mortgage Securities Association; Thomson Reuters

Graph 24

Global Equity Issuance

12-month rolling average, quarterly



* March 2010 quarter is quarter to date
Source: Bloomberg