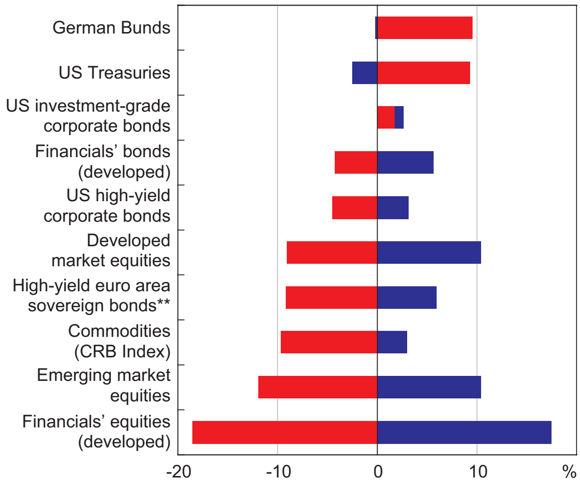
1. The Global Financial Environment

Conditions facing the global financial system deteriorated in the second half of 2011 associated with the escalation of the sovereign debt crisis in the euro area. Banks in the euro area came under severe funding strain, compounding the difficulties they were facing from weaker economic activity in the region; this raised the risk of an adverse feedback loop between the economy and financial system. These problems triggered a period of heightened risk aversion and volatility in global financial markets, with the prices of risk assets in a range of markets falling sharply over the second half of 2011 (Graph 1.1). Bank funding conditions outside the euro area tightened, and bank share prices declined as markets became increasingly concerned about the implications of a European crisis for the global financial system (Graph 1.2).

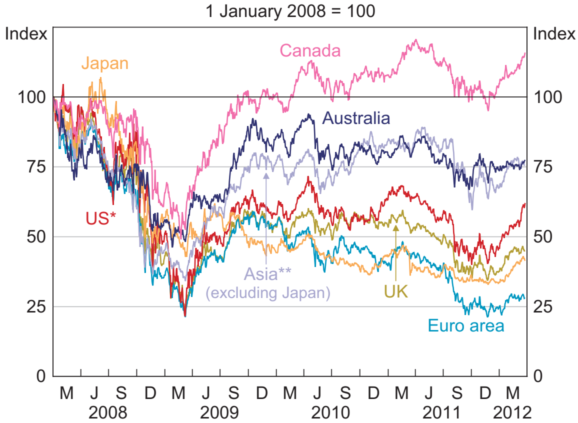
Since late December, there has been a notable turnaround in global financial market sentiment reflecting actions taken by the European Central Bank (ECB) to support euro area bank liquidity and other policy steps to address the sovereign debt problems in the region. The improvement has been evident in a return of global risk appetite; bank funding pressures have eased somewhat; and bank share prices in most major markets have recovered much of the decline they recorded in the second half of 2011. Even though market confidence has improved, risks to global financial stability remain: financial systems are susceptible to any further setbacks in dealing with the sovereign debt problems in Europe, and the near-term outlook for growth in the major advanced countries is subdued, which could affect the outlook for banks' asset quality and profitability. Overall, though, the major banking systems should

Graph 1.1
Asset Prices*
Per cent change



* Sovereign bonds and financials' bonds (developed) have maturities of 7–10 years
** Simple average of Greece, Ireland, Italy, Portugal and Spain
Sources: Bloomberg; MSCI; RBA

Graph 1.2
Banks' Share Prices
1 January 2008 = 100



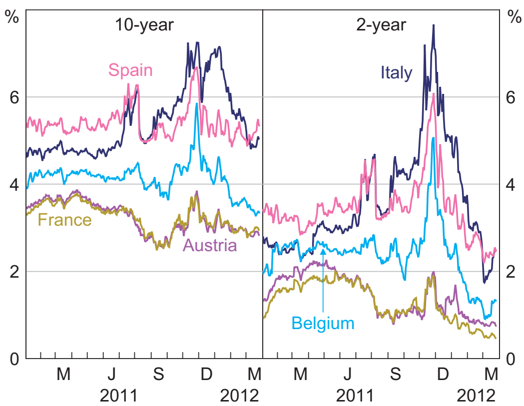
* Market capitalisation-weighted index of 18 large banks
** MSCI financials index
Source: Bloomberg

be better positioned than they were before the 2008–2009 crisis to deal with periods of renewed stress, given the strengthening of many large banks' capital and funding positions over recent years.

Sovereign Debt Problems in Europe

Market concerns about sovereign debt sustainability in the euro area spread to a wider range of countries over the second half of 2011. The focus was initially on the larger economies of Italy and Spain; yields on these sovereigns' bonds increased sharply during July and August, prompting the ECB to extend its sovereign debt purchase program to these bonds (Graph 1.3). Yields subsequently rose markedly across a broader range of euro area sovereigns (including France) as markets became increasingly pessimistic about the European authorities' ability to deal with the growing crisis. Political instability in several euro area countries and speculation that some countries might leave the euro area contributed to the market uncertainty. Euro area bank funding markets became impaired, raising fears of a banking crisis in the region that would be difficult to resolve given the precarious fiscal positions in some countries (see section on 'Bank Funding Conditions and Markets'). Yields also increased on sovereign bonds of some countries in emerging Europe, consistent with the strong financial and economic connections between these regions.

Graph 1.3
Euro Area Government Bond Yields



Source: Bloomberg

European policymakers announced several measures in late 2011 to address the escalating sovereign debt crisis. These included: a new fiscal treaty covering nearly all European Union (EU) countries, with enforceable rules and penalties; strengthening regional assistance by accelerating the introduction of the permanent European Stability Mechanism and the leveraging of the European Financial Stability Facility (EFSF); and additional funding of potential assistance via the International Monetary Fund (IMF). At the national level, a number of countries announced further fiscal consolidation measures, including Italy, Portugal and Spain. EU authorities also initiated several policies to buttress confidence in banking systems, given the interlinkages between sovereign and bank balance sheets. As discussed further below, these included the ECB's provision of three-year loans to banks, and higher capital requirements for larger European banks.

Sentiment in euro area sovereign debt markets has improved considerably since the end of 2011. The ECB's long-term lending seems to have been the main circuit-breaker, although sentiment has also been buoyed by the gradual steps to address fiscal issues. Banks, particularly Italian and Spanish banks, appear to have invested some of their ECB borrowing in euro area sovereign debt. Yields on Italian and Spanish 2-year government bonds have declined by about 4 and 2½ percentage points, respectively, since mid December. Market confidence in Italian sovereign debt has also been boosted by the fiscal and structural reforms recently announced by the new government in Italy. Despite these positive developments, policy measures still need to be successfully implemented and further action may be required to put some countries on a sustainable fiscal path.

There has also been progress in dealing with Greece's sovereign debt problems, which have been creating market uncertainty for some time. In early March, the Greek Government reached agreement with private sector creditors to restructure their holdings of Greek government debt, cutting its private debt by about €100 billion. Almost 85 per cent of private sector creditors participated in a voluntary exchange of their Greek government bonds for short-term EFSF notes and new long-term Greek government bonds – measures which equate to a loss to these investors of more than 70 per cent in net present value terms. Most other private sector creditors were forced to accept losses after the Greek Government activated collective action clauses that allowed it to force losses on all private sector creditors once a required majority of creditors had accepted the bond exchange. Following the restructuring and other initiatives, the EU and IMF have agreed to make further disbursements to Greece under its assistance programs, conditional on the outcomes of quarterly reviews of Greece's adherence to the programs' terms.

The Greek debt restructuring, together with the substantial fiscal consolidation measures being taken by the Greek Government, have significantly reduced Greece's future debt-service burden. Its stock of government debt is projected to fall to around 120 per cent of GDP by 2020, from 165 per cent in 2011. However, the debt-service burden remains high; it will be a challenge to keep Greek government finances on a sustainable path, given that the Greek economy is contracting sharply.

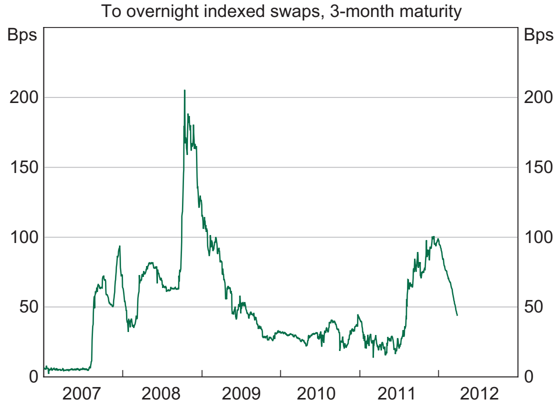
The relevant industry association, the International Swaps and Derivatives Association, ruled that the activation of collective action clauses constituted a 'credit event' for credit default swaps (CDS) referencing Greek sovereign debt. The CDS payout rate was determined by auction to be 78.5 per cent. The total net notional value of CDS referencing Greek sovereign debt was US$3.1 billion at the time of the auction.

Bank Funding Conditions and Markets

Bank funding difficulties in the euro area were initially centred on banks in the most troubled euro area countries – Greece, Ireland and Portugal. But as market attention shifted to a broader range of countries, particularly Italy and Spain, funding pressures spread to the wider euro area banking system. Short-term bank funding markets became increasingly strained, with euro unsecured interbank borrowing spreads widening by about 60 basis points between August and November 2011, to the highest levels since early 2009 (Graph 1.4). The cost of swapping euros into US dollars in the foreign exchange market also increased considerably, in part because US money market funds, which are significant providers of short-term US dollar liquidity to euro area banks, cut their exposures to the region. While these funds had already all but stopped lending to banks in the more troubled euro area countries, they also reduced, and shortened the maturity of, their lending to French banks during the second half of 2011 (Graph 1.5). Outflows of private sector deposits contributed to the funding pressures of banks in a few countries.

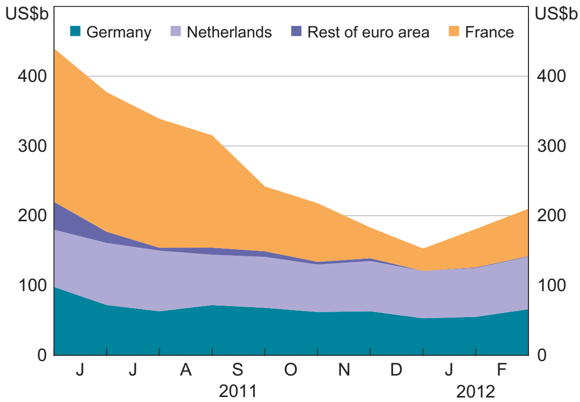
Term funding markets were also disrupted. Euro area bank bond yields rose sharply in the second half of 2011, particularly for lower-rated issuers (Graph 1.6). Premia on CDS contracts referencing large euro area banks' long-term debt increased to levels well above their previous peaks recorded during the 2008–2009 crisis. As a result, bank bond issuance in the euro area declined noticeably in the second half

Graph 1.4
Euro Unsecured Interbank Borrowing Spread
To overnight indexed swaps, 3-month maturity



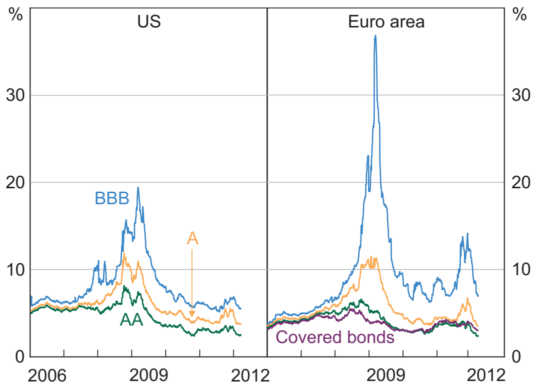
Source: Bloomberg

Graph 1.5
US Prime Money Market Funds
Estimated value of euro area bank exposures, by country



Sources: JPMorgan; RBA

Graph 1.6
Banks' Bond Yields

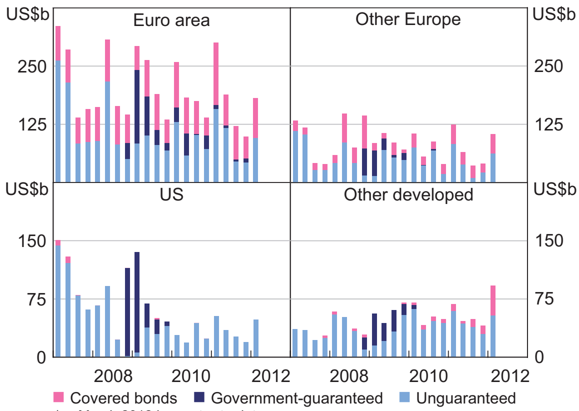


Source: Bloomberg

of 2011, to about one-half the average level seen over the previous two years; unsecured issuance was particularly low (Graph 1.7). Some euro area banks were effectively shut out of the bond market for a few months towards the end of the year, which increased their near-term refinancing risks. Around €250 billion of euro area bank bonds were due to mature in the first quarter of 2012, or 9 per cent of the outstanding stock, of which nearly 30 per cent were government guaranteed. The Belgian-French bank Dexia, the 13th largest bank in the euro area, became distressed due to its reliance on wholesale funding. The Belgian, French and Luxembourg governments announced a plan to break up and nationalise the bank in late 2011, less than three years after the bank had received a sizeable government capital injection and guarantees as part of a 2008 rescue.

The recent funding pressures of euro area banks were exacerbated by widespread downgrades to their credit ratings (Graph 1.8). The downgrades were partly in response to downgrades of their home countries' sovereign credit rating, as well as deteriorating financial and economic conditions in their core markets. Many banks in the most troubled euro area countries have now had their ratings downgraded to non-investment grade status, contributing to their funding difficulties. Globally, recent bank credit ratings downgrades have also

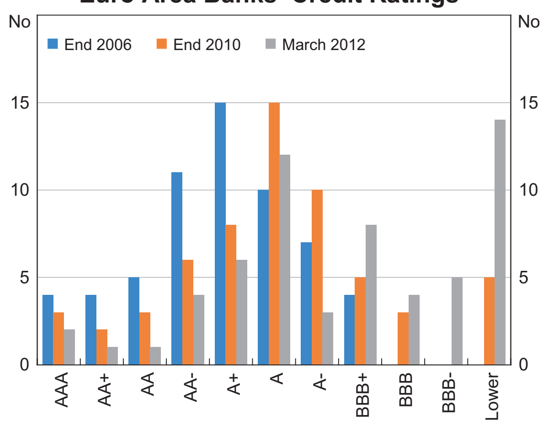
Graph 1.7
Banks' Bond Issuance*



* March 2012 is quarter-to-date

Sources: Bloomberg; Dealogic; RBA; Thomson Reuters

Graph 1.8
Euro Area Banks' Credit Ratings*

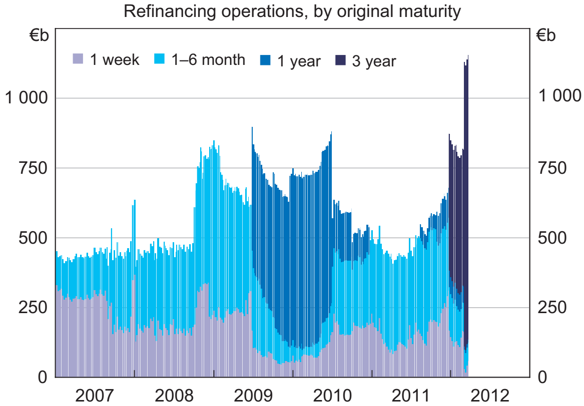


* Fixed sample of 60 large institutions from across the euro area; predominantly Standard & Poor's local long-term ratings, unless unrated, then Moody's senior unsecured

Sources: Moody's; RBA; Standard & Poor's reflected a number of technical factors, including: lower perceived sovereign support of banks (for example, in the United Kingdom); and changes to Standard & Poor's bank rating methodology.

The ECB responded to the funding difficulties in the euro area banking system by conducting two special long-term liquidity operations, one in mid December 2011 and one in late February 2012. These operations allowed banks to take three-year collateralised (but otherwise unlimited) loans at the ECB's policy rate; previously ECB loans had only been available at maturities of one year or less. At its December operation, the ECB provided nearly €490 billion to more than 500 banks, of which around €190 billion was new lending (the difference was loans maturing or rolled into three-year loans) (Graph 1.9). Lending to banks located in Italy increased particularly sharply, while significant increases were also recorded for banks in Belgium, France, Germany and Spain. There was further strong take-up of the ECB's second operation in February: nearly €530 billion was provided to 800 banks, with net new lending amounting to €314 billion. Taken together, these operations have left banks in the region well placed to fund their aggregate bond maturities for at least the first half of the year. The ECB and some national central banks also introduced other measures that improved access to liquidity, including broadening the range of eligible collateral for liquidity operations,

Graph 1.9
ECB Lending for Monetary Policy Operations
Refinancing operations, by original maturity



Sources: ECB; RBA

and halving banks' required reserves ratio. The reintroduction of a government guarantee of bank debt securities in Italy in December allowed Italian banks to issue guaranteed bonds to themselves that were acceptable collateral at the ECB. In early December, the major central banks reduced the cost of the US dollar swap facility they provide to banks, which helped ease US dollar funding pressures.

Market sentiment and funding conditions have improved significantly since the ECB's first three-year loan operation. The operation effectively addressed the near-term refinancing needs of many banks and helped quell fears of a euro area banking crisis. Accordingly, CDS premia for large euro area banks have since declined considerably and bank share prices have increased. Short-term funding costs have retraced much of their run-up since mid 2011, although some banks are still reluctant to lend to other banks on an unsecured basis except at very short maturities. Bank bond yields have also declined and issuance has picked up in the early part of this year, although mainly for higher-rated banks. However, it is not clear if banks that have borrowed heavily from the ECB can transition smoothly back to market-based funding over the next few years.

Bank funding markets tightened in other countries over the latter part of 2011, although less so than in the euro area. Short-term unsecured borrowing spreads increased in the United States and the United Kingdom, for example, while banks' long-term wholesale funding costs also rose in a number of markets. As in the euro area, bond issuance by banks elsewhere slowed in the second half of 2011, but has since picked up as yields have eased.

In the past year, bank bond issuance has been more heavily weighted towards covered bonds than usual: across the major banking systems, covered bonds have accounted for about 35 per cent of issuance since 2011, compared with an average of about 25 per cent over 2007–2010. This shift has been encouraged by investor risk aversion and regulatory incentives. While covered bonds have been providing banks with a cheaper source of funding in the current environment, they encumber assets, leaving unsecured creditors worse off. This could result in higher unsecured funding costs for banks at some point in the future. Asset encumbrance is a particular issue in Europe, where covered bonds represent a larger share of banks' balance sheets, and where collateralised borrowing in short-term funding markets and from the ECB is contributing to greater asset encumbrance. Some investors and regulators have become concerned that overall levels of encumbrance are not being adequately disclosed.

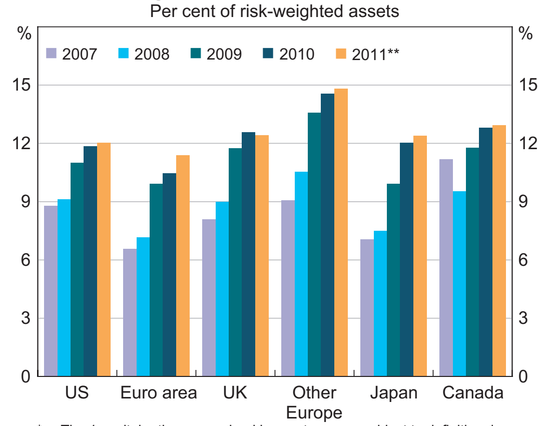
Bank Capital Positions and Deleveraging

Bank capital positions have been strengthened substantially since 2008, improving the resilience of the major banking systems compared with their pre-crisis standing (Graph 1.10). Higher bank capital ratios over this period have primarily reflected increases in the level of Tier 1 capital, but assets and/or average risk weights have also declined, as banks adjusted to more appropriate post-crisis business models and tougher regulatory settings (Graph 1.11). Although this deleveraging process has been underway at many banks since the crisis, recent funding and capital pressures raised concerns of a more disorderly adjustment in the euro area.

In response to both sovereign debt exposures and weak economic outlooks, bank regulators in a number of the most troubled euro area countries (including Greece, Ireland, Portugal and Spain) introduced higher minimum capital requirements for their banks in late 2010 and early 2011. But pressures to strengthen capital buffers across the broader euro area banking system increased in the second half of 2011 as the sovereign debt problems spread.

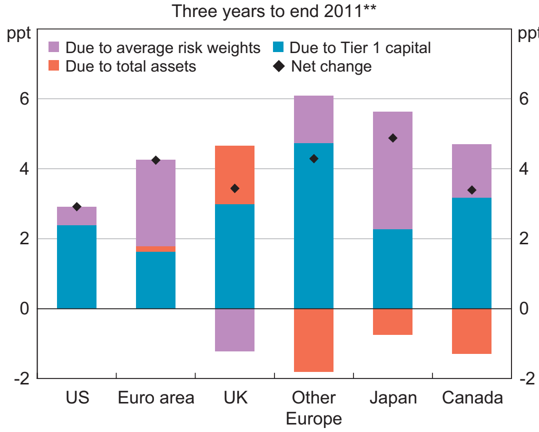
The European Banking Authority (EBA) announced in October that 65 large EU banks (accounting for about 60 per cent of EU bank assets) would be required to meet a temporary 9 per cent core Tier 1 capital ratio by June 2012, as well as a temporary buffer to allow for valuation losses on their EU sovereign debt exposures.[1] In December, the EBA identified 31 banks with capital shortfalls, totalling

Graph 1.10
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 five largest UK banks, 13 large other European banks, the three largest Japanese banks and the six largest Canadian banks
** End September 2011 data used for euro area institutions where end 2011 data are unavailable
Sources: Bloomberg; CEBS; EBA; FDIC; RBA; banks' annual and interim reports

Graph 1.11
Change in Large Banks' Tier 1 Capital Ratios*
Three years to end 2011**



* 19 large US banks, 52 large institutions from across the euro area, the five largest UK banks, 13 large other European banks, the three largest Japanese banks and the six largest Canadian banks
** End September 2011 data used for euro area institutions where end 2011 data are unavailable
Sources: Bloomberg; EBA; FDIC; RBA; banks' annual and interim reports

1 The temporary 9 per cent core Tier 1 capital ratio for large EU banks compares with the 7 per cent common equity Tier 1 capital ratio (including conservation buffer) required by 2019 under Basel III. Core Tier 1 capital in the EBA plan uses the Basel II definition of high-quality capital, which is less strict than the forthcoming Basel III definition.

€85 billion, including €40 billion for the sovereign exposures buffer (Table 1.1). (Greek banks were not directly included in the EBA plan because the EU/IMF assistance package for Greece had already set aside funds to recapitalise these banks.) Spanish, Italian and German banks were found to have the largest aggregate capital shortfall, while participating banks outside the euro area had little or none.

With bank share prices still depressed, issuing new capital is expensive. The EBA's capitalisation targets therefore fuelled concerns that banks would seek to meet the targets through asset sales and reduced

Table 1.1: EU Banks' Capital Requirements
By country, as at September 2011

	Aggregate core Tier 1 capital	Capital shortfall[(a)]		Of which: sovereign buffer
	Per cent of risk-weighted assets	€ billion	Per cent of risk-weighted assets	€ billion
Austria	7.5	3.9	1.5	0.1
Belgium	8.8	6.3	2.7	4.8
Cyprus	7.0	3.5	6.5	2.5
Denmark	13.7	0.0	0.0	0.0
Germany	9.0	13.1	1.0	7.6
Finland	11.1	0.0	0.0	0.0
France	8.9	7.3	0.4	3.5
Hungary	12.5	0.0	0.0	0.0
Ireland	17.5	0.0	0.0	0.8
Italy	8.5	15.4	1.4	9.7
Luxembourg	13.8	0.0	0.0	0.0
Malta	10.5	0.0	0.0	0.0
Netherlands	10.5	0.2	0.0	0.2
Norway[(b)]	7.8	1.5	1.2	0.0
Poland	11.2	0.0	0.0	0.0
Portugal	7.6	6.9	3.0	3.7
Slovenia	7.5	0.3	1.7	0.0
Spain	7.5	26.2	1.9	6.6
Sweden	12.4	0.0	0.0	0.0
United Kingdom	10.1	0.0	0.0	0.0
Total	**9.4**	**84.7**	**0.8**	**39.4**
Memo item:				
Greece[(c)]	*na*	*~50.0*	*na*	*na*

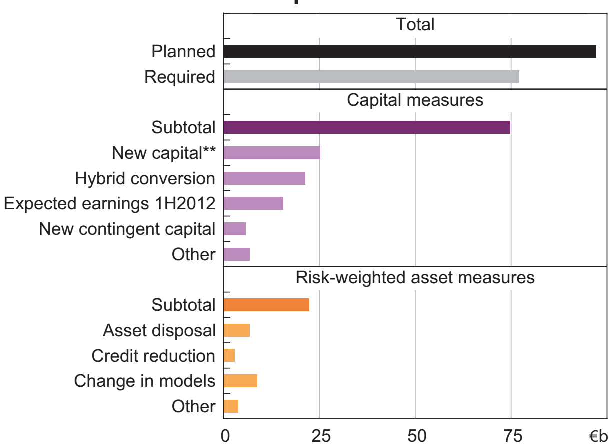
(a) Capital required to meet a 9 per cent core Tier 1 capital ratio, as well as a buffer for valuation losses on EU sovereign exposures at end September 2011; these requirements must be met by June 2012; the sovereign buffer does not contribute to the capital shortfall if banks have capital above the 9 per cent core Tier 1 capital ratio, after accounting for losses on sovereign exposures (e.g. the Irish banking system)
(b) Norway is not part of the EU, but one Norwegian bank participated because it has significant exposures in some EU countries
(c) Based on IMF estimates of Greek banks' recapitalisation needs as at March 2012
Sources: EBA; IMF

lending, particularly given the ongoing funding pressures they faced. While sales of assets by banks need not be harmful to financial stability, especially if the assets are bought by investors who are better able to fund them, the fear was that forced asset sales and lending cuts could destabilise financial markets and weaken economic activity. To alleviate these concerns, the EBA directed national bank supervisors to accept asset sales as part of banks' capital plans only if they did not reduce the flow of lending to the EU real economy.

The EBA's preliminary assessment of the banks' capital plans in February indicated that the banks had identified actions that would give an aggregate capital surplus of 26 per cent above the identified shortfall, providing leeway in case some actions did not materialise (Graph 1.12). The bulk of the actions were direct capital measures, mainly retained earnings and conversion of hybrids to common equity. Asset sales and other balance sheet adjustments accounted for only a small part of the recapitalisation.

While these capital plans and recent actions helped allay market fears of significant asset shedding by banks with capital shortfalls, some euro area banks continue to sell assets as part of their longer-term

Graph 1.12
EU Banks' Recapitalisation Plans*



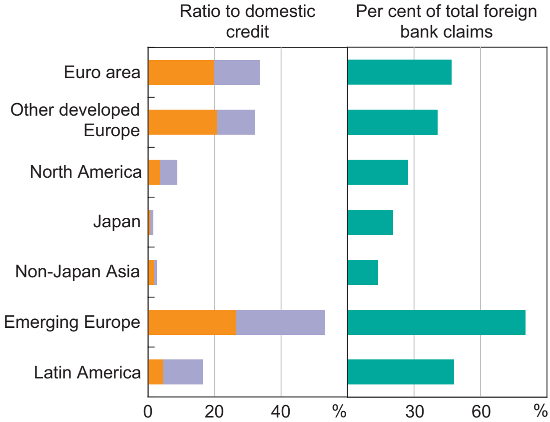
* Excludes three banks with capital shortfalls that are undertaking significant restructuring
** Includes retained earnings from 4Q2011, scrip dividends and new capital issuance
Source: EBA

strategies. For instance, some French, German and Spanish banks have sold high-risk or US dollar assets, or divested some foreign operations, to refocus on their core activities or reduce their need for US dollar funding. In addition, some large UK and Swiss banks are continuing to contract and/or de-risk their balance sheets in order to meet upcoming tough domestic capital rules or the expectations of public sector shareholders. Asset sales are also scheduled for a number of banks that are in the process of being restructured or wound down, including Dexia. Industry estimates of overall asset disposals by European banks over the coming years range from €0.5 to €3 trillion, or about 1–7 per cent of European banks' assets.

A significant amount of asset shedding seems to have been in advanced country markets, but there have also been concerns about the impact on those emerging market regions where European banks have a large presence. Emerging Europe would appear to be the most vulnerable given that euro area banks dominate many banking systems in this region; they also have significant market shares in some parts of Latin America (Graph 1.13). These concerns spurred European and other multilateral authorities recently to reconvene discussions with national authorities and the major cross-border banks under the European Bank Coordination 'Vienna' Initiative, established during the 2008–2009 financial crisis. These discussions are also aimed at the longer-term objective of increasing the share of credit that is funded locally in some emerging European banking systems, which should improve these economies' resilience to foreign funding and capital shocks.

Euro area banks' claims on emerging market regions declined by about 8 per cent over the September quarter 2011 (the latest available data), reflecting falls in lending to non-Japan Asia, emerging Europe and Latin America. New syndicated and large bilateral loans from European banks to emerging market borrowers fell noticeably in the December quarter, pointing to a further decline in euro area banks'

Graph 1.13
Euro Area Banks' Foreign Claims on Selected Regions*



* Consolidated claims of reporting banks on an immediate borrower basis; as at September 2011; some countries that account for a small share of foreign claims are excluded from non-Japan Asia, emerging Europe and Latin America

** Includes cross-border claims, and local claims denominated in foreign currency

Sources: BIS; IMF; RBA; national sources

outstanding lending. But these declines could partly reflect lower demand: syndicated loan approvals in non-Japan Asia, for example, fell sharply in the December quarter across banks from all regions (see Graph 1.22).

Outside of the euro area, increases in banks' capital positions over the past year were generally modest compared with those in 2009 and 2010. Banks largely built up their capital positions by retaining earnings, supported by dividend payout ratios that are still below pre-crisis levels. Capital ratios in the major banking systems also continued to benefit from slow growth in risk-weighted assets, reflecting subdued credit growth and some deliberate asset shedding. Some large banks in the United States have announced plans to distribute additional capital to shareholders in 2012, mainly via increases in their dividends or share buybacks. The US Federal Reserve approved most large US banks' capital plans after they remained above required minimum capital ratios under adverse scenarios included in its latest round of supervisory stress tests.

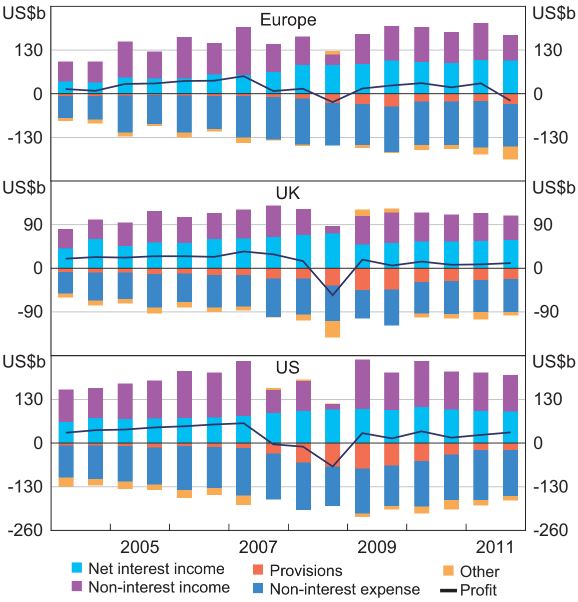
Although bank capital positions in the major advanced countries have increased significantly over the past few years, many banks will need to further strengthen their capitalisation to meet the tougher regulatory standards being phased in over coming years. Some banks will need to increase their common equity positions to meet Basel III requirements, and in some cases, the extra capital buffers that are to apply to global systemically important banks (see 'Box C: Global Systemically Important Banks'). As discussed in the chapter on 'Developments in the Financial System Architecture', large banks in some jurisdictions will also be required to hold additional capital and meet other requirements if they are deemed systemically important to the domestic financial system.

Bank Profitability

The profitability of the large banks in Europe, the United Kingdom and the United States generally declined in the second half of 2011. Banks' non-interest income fell significantly as market uncertainty and volatility reduced the demand for investment banking services and resulted in trading book losses, especially at euro area banks (Graph 1.14). With credit growth remaining weak and higher funding costs weighing on net interest margins, most of these banks also recorded little or no growth in their net interest income. A number of the large banks in Europe recorded sizeable asset write-downs, including from reductions in goodwill and further impairments on their holdings of Greek sovereign bonds. Some of the large US banks continued to incur sizeable charges related to previous poor mortgage practices.

Most banks' loan-loss provisions were broadly steady in the second half of 2011 (excluding provisions for Greek debt), in contrast to the previous two years, when sharp declines in provisions had supported their profit growth. The main exception to this was in Spain, where further weakness in the property market required additional provisions. To address vulnerabilities related to property development

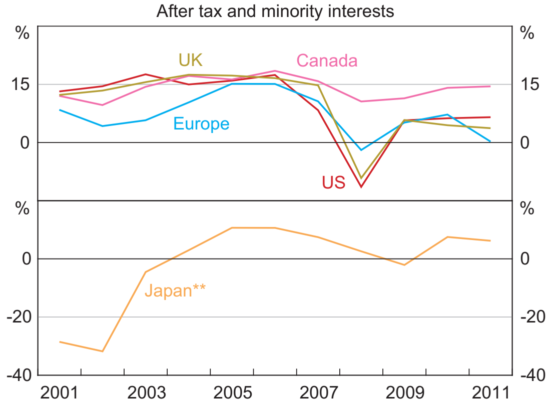
Graph 1.14
Large Banks' Profit*
Semi-annual



* Profits of the six largest US banks, 10 largest listed European banks (including Switzerland) and five largest UK banks; adjusted for significant mergers and acquisitions; 2011 profit is annualised for one European bank

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

Graph 1.15
Large Banks' Return on Equity*
After tax and minority interests



* Return on equity of the six largest US banks, 10 largest listed European banks (including Switzerland), five largest UK banks, four largest Japanese banks and six largest Canadian banks; adjusted for significant mergers and acquisitions; 2011 profit is annualised and total equity is assumed constant from last reporting date for one European bank

** 2001–2007 results are to fiscal year ended 31 March

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

exposures, the Spanish authorities have required their banks to raise an additional €50 billion in provisions in 2012, on top of the €100 billion or so these banks have raised since early 2008.

The combination of modest profits and higher capitalisation meant that returns on equity for the major banking systems were subdued in 2011. European banks' average returns were only slightly positive, while returns for large banks in the United Kingdom and the United States averaged between 4 and 7 per cent, similar to the rates recorded in 2009 and 2010 but well below those seen in the pre-crisis period (Graph 1.15). Even outside the euro area, a number of the large banks have responded to low profitability by selling underperforming business units and cutting costs, such as by reducing staff numbers. Cutbacks have been most pronounced in investment banking, given recent weak returns and tougher regulation for some of these activities.

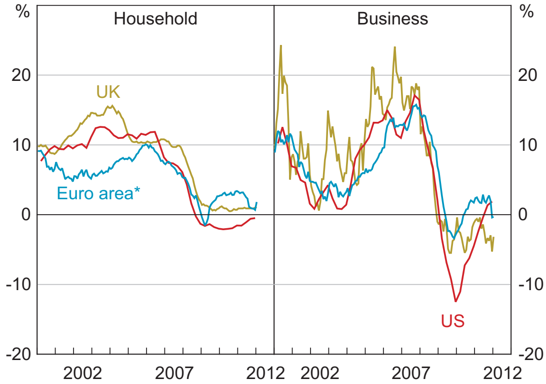
Compared with most of their international peers, the large Canadian banks posted a higher average return on equity of 14 per cent in 2011. Their relatively strong balance sheets have allowed them to make a number of acquisitions and overseas expansions during the past year. Japanese banks are also looking to expand offshore as they seek to boost their returns above what they can achieve domestically.

Credit Conditions and Asset Quality

In the euro area, the pressures on banks' balance sheets were associated with a noticeable slowing in region-wide credit growth towards the end of 2011, and sharp falls in credit in southern euro area countries and Ireland (Graph 1.16). Lending surveys showed a marked increase in the balance of euro area lenders tightening their standards on household and business loans in the September and December quarters of 2011, which points to supply-side factors as being important to this slowing (Graph 1.17). The tightening was particularly pronounced in Italy, but it was evident across a number of large euro area countries, with the notable exception of Germany. It should be noted, however, that these survey results predate the impact of the ECB's December and February three-year lending operations.

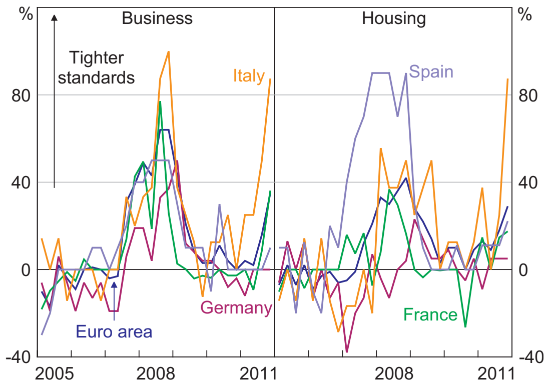
Graph 1.16
Credit Growth

Six-month-ended, annualised, seasonally adjusted



* Euro area data not adjusted for securitisations prior to 2009
Sources: Bank of England; ECB; RBA; Thomson Reuters

Graph 1.17
Euro Area Credit Standards*



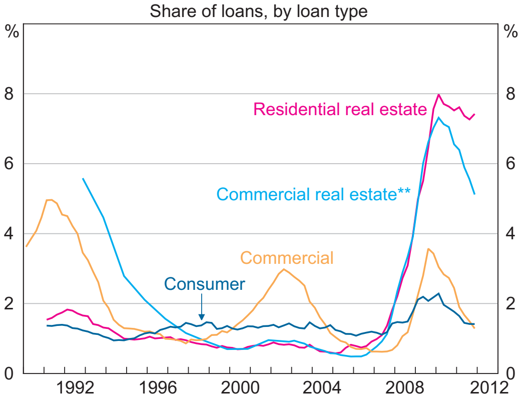
* Net percentage reporting tighter standards
Sources: ECB; national central banks

The constraints on euro area banks' balance sheets and capital positions pose a risk that they will further inhibit credit supply. The euro area economy is fairly reliant on bank credit; large businesses issue relatively little non-intermediated debt and, as elsewhere, households and small businesses do not have access to debt capital markets at all. A reduction in bank credit supply would therefore exacerbate the recent downturn in economic activity in the region, in turn weakening banks' own asset performance and financial positions. However, the ECB's recent long-term lending has ensured that a lack of funding does not act as a constraint on euro area banks' capacity to lend, which may improve credit supply in the region in the period ahead.

Credit growth also remains weak in the United Kingdom and the United States, but this seems to be mainly due to soft demand. In particular, the level of household credit has been falling in the United States, consistent with difficult housing market conditions and high household debt burdens. Business credit has also declined over the past six months in the United Kingdom, as businesses have continued to repay debt and net bond issuance has picked up. However, authorities continue to be concerned about the availability of credit for small businesses. After a prolonged period of contraction, business credit expanded modestly in the United States over the second half of 2011, consistent with the pick-up in business investment. Loan standards reported by banks in these two countries have been broadly unchanged over the past six months, although they have tightened on some product lines, such as US banks' loans to businesses exposed to Europe and to banks headquartered in Europe.

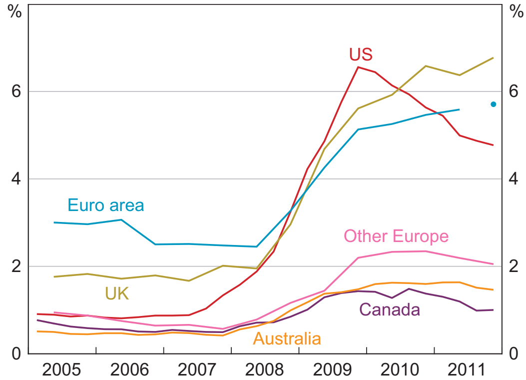
Persistent concerns over asset quality are continuing to weigh on the outlook for banks in the major markets. While provisions for loan losses have generally declined from crisis peaks, they remain above historical levels, consistent with elevated non-performing loan ratios. Property-related exposures remain a key vulnerability, especially in the United States: many banks there are still dealing with a large overhang of non-performing commercial and residential real estate loans, which continue to contribute to bank failures (Graph 1.18). Around 100 small Federal Deposit Insurance Corporation (FDIC) insured institutions have failed since the start of 2011; although this is only about 1 per cent of all US FDIC-insured institutions, more than 10 per cent of institutions are still considered vulnerable by the FDIC, slightly above the 1990s peak. Non-performing ratios for commercial and consumer loans in the United States have declined to around their long-run average levels, consistent with the recovery in parts of the United States economy not exposed to real estate.

Graph 1.18
US Non-performing Loans*
Share of loans, by loan type



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

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

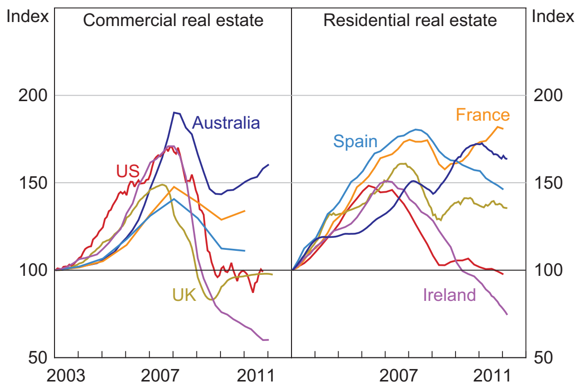


* Definitions of 'non-performing' differ across jurisdictions, and in some cases exclude loans that are 90+ days past due but not impaired; includes 18 large US banks, 52 large institutions from across the euro area, 12 large other European banks, the five largest UK banks, the six largest Canadian banks and the four largest Australian banks; latest available ratios have been used for some euro area institutions where end 2011 data are unavailable
Sources: APRA; Bloomberg; FDIC; RBA; banks' annual and interim reports

In the euro area and the United Kingdom, large banks' non-performing loan ratios have continued to drift up over the past few years (Graph 1.19). The available nationwide data indicate that these ratios have recently increased further in Ireland and Spain, countries that experienced particularly large booms and busts in property development. Banks' asset performance could come under further pressure in those euro area countries where economic and financial conditions have deteriorated significantly of late, and where substantial fiscal tightening is underway.

Many commercial and residential property loan exposures are still likely to be in negative equity, as property prices remain well below their peaks in most advanced countries (Graph 1.20). Indeed, in a number of countries, property prices have not yet begun to show any significant recovery. A large inventory of properties that are in protracted arears or in foreclosure continue to weigh on housing market prospects in the United States. Banks in some countries have been forbearing on problem property (and other) loans, via measures such as extending loan maturities and converting loans to interest-only terms. While these actions may have helped some borrowers to cope with temporary financial difficulty and avoided the need for lenders to sell assets into already depressed markets, they may increase the need for provisions against losses in the event that economic and property market conditions turn out weaker than expected.

Graph 1.20
Property Price Indicators
31 December 2002 = 100



Sources: Bloomberg; Jones Lang LaSalle Research; Property Council of Australia; RBA; RP Data-Rismark; Thomson Reuters

Banking Systems in the Asian Region

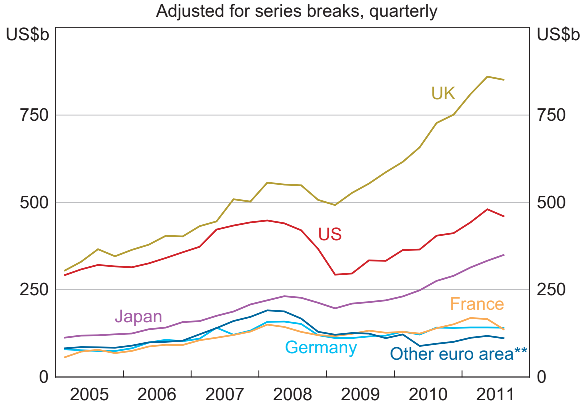
Financial markets in the Asian region were affected by the deepening of the euro area sovereign debt crisis late last year. The increase in risk aversion saw large net outflows from emerging Asian equity funds, which contributed to falls in equity prices and currency depreciations across the region. These movements have been partially reversed this year as capital has flowed back into the region. Given their domestic focus, Asian banking systems have little direct asset exposure to euro area countries and their relatively low reliance on wholesale funding sources also partly insulated them from the funding market strains that developed late last year. However, the global tightening in US dollar liquidity did make it more costly for some banks to obtain US dollar funding in the foreign currency swap market.

The pressures on euro area banks have seen some of them scale back their lending in the Asian region. In aggregate, euro area banks reduced their claims on non-Japan Asia by about 9 per cent over the September quarter 2011 (the latest available data). The decline was driven by a fall in lending by French banks; more recent reports suggest that some of these banks have sold portions of their Asian syndicated loan portfolios (Graph 1.21).

While euro area banks' total claims on non-Japan Asia are still relatively small – equivalent to less than 5 per cent of domestic credit in the region – some euro area banks are bigger players in trade finance and other specialised lending areas such as aircraft, shipping and project financing, on which some Asian economies are more reliant. These types of lending may be particularly susceptible to pullback by euro area banks as they are mainly denominated in US dollars. A recent IMF survey suggests that supply of trade finance tightened in Asia and globally over late 2011. A significant disruption to trade finance could have an adverse effect on trade flows and economic activity in the Asian region, particularly the more export-oriented economies of south-east Asia. It is not clear if other banks can pick up this business easily, because it requires US dollar funding and specialist skills, but reports suggest that some banks that already have a presence in the market are expanding their business, including banks from emerging Asia, Australia and Japan. Banks from these regions have increased their involvement in Asian syndicated loan markets following the 2008–2009 crisis, largely offsetting declines by euro area and North American banks (Graph 1.22).

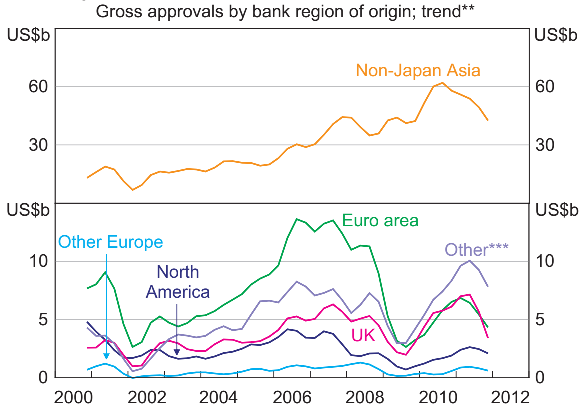
Concerns about cutbacks in lending by euro area banks also need to be weighed against strong domestic credit growth across the Asian region over recent years. Asset prices have increased significantly in a few economies, in particular, residential property prices in Hong Kong SAR, Taiwan, Singapore

Graph 1.21
Foreign Banks' Claims on Non-Japan Asia*
Adjusted for series breaks, quarterly



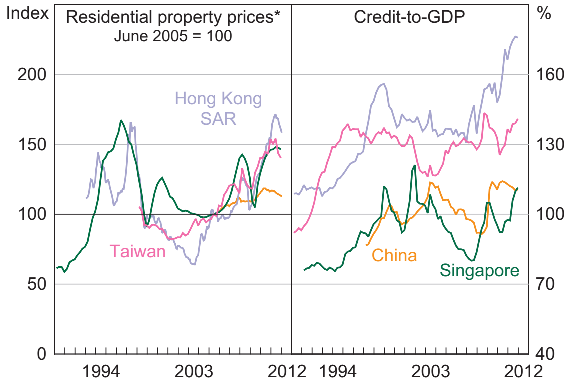
* Consolidated claims of reporting banks on an immediate borrower basis; non-Japan Asia is comprised of China, Hong Kong SAR, India, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand
** Includes Belgium, Greece, Italy, Netherlands, Portugal, Spain
Sources: BIS; RBA

Graph 1.22
Syndicated Loans in Non-Japan Asia*
Gross approvals by bank region of origin; trend**



* Where the contribution of individual banks to a syndicated loan is unknown it is assumed that the loan is evenly distributed between participating banks; non-Japan Asia includes Central Asia
** 7-period Henderson trend
*** Predominantly Japan but also includes a noticeable contribution from Australia
Sources: RBA; Thomson Reuters

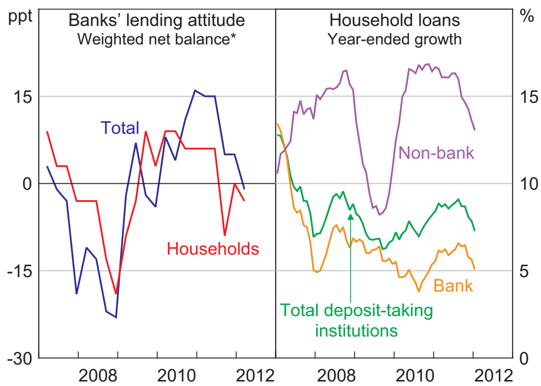
Graph 1.23
Asset Prices and Credit



* Adjusted for inflation; for China, data are an average of new and existing residential property prices

Sources: CEIC; Central Bank of Taiwan; Hong Kong Monetary Authority; Monetary Authority of Singapore; RBA

Graph 1.24
Korea – Household Credit Conditions



* Of respondents reporting tighter/looser lending attitude; survey is conducted at the start of each quarter

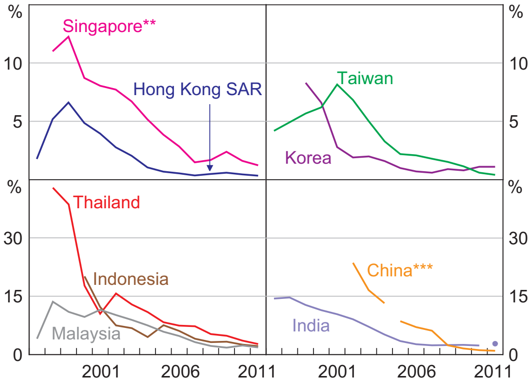
Source: Bank of Korea

and some large cities in China (Graph 1.23). This prompted authorities in these economies to introduce a range of targeted measures in 2010 and early 2011, including increases in minimum down-payment requirements, new or higher taxes on certain property sales, and restrictions on certain property purchases. Residential property prices have declined modestly across these economies over the past six months, although they remain relatively high. Fears of a sharp correction in property prices have been weighing on Chinese banks' share prices, given the adverse effect this would have on banks' exposures to property developers and to local government financing vehicles (some of which rely heavily on land-based revenues).

Korean authorities have also recently introduced policies to address vulnerabilities in their financial system. A number of measures were taken in 2010 and 2011 to reduce banks' reliance on foreign funding, including a levy on banks' foreign currency wholesale funding and tighter restrictions on banks' foreign currency derivative positions. In addition, large banks will be required to meet a maximum loan-to-deposit ratio of 100 per cent, to reduce their reliance on wholesale funding. Large banks' loan-to-deposit ratios declined over 2011, as they raised deposits ahead of this policy coming into force in mid 2012. The authorities also announced a range of measures in mid 2011 to address growing household indebtedness and rapid growth in lending by less-regulated credit providers. These include: mandating higher risk weights on banks' high-risk mortgages and mortgage loan concentrations; tightening capital and provision requirements for non-bank lenders; proposals to strengthen consumer protection; and tax incentives for households to repay principal on their mortgages and use debit cards rather than credit cards. Consistent with these measures, banks lowered their appetite for household lending last year. However, annual growth in overall household lending slowed only a little and non-bank lending growth remains strong despite its recent decline (Graph 1.24). This might be partly because the capital requirements and other measures affecting banks were more stringent than for non-banks.

At this stage, Asian banking system loan portfolios have generally not deteriorated, despite tighter monetary policy and/or prudential policy over the past year. Non-performing loan ratios were broadly steady or declined slightly over 2011 (with the exception of India), and are currently around their lowest levels since at least prior to the Asian financial crisis in the late 1990s (Graph 1.25). Capital buffers have increased over recent years to fairly high levels,

Graph 1.25
Non-Japan Asia – Non-performing Loans*
Share of loans



* Definitions of 'non-performing' differ across jurisdictions; dot represents September quarter estimate
** Domestic banks only
*** Data from 2002–2004 are for major commercial banks only
Sources: CEIC; RBA; banks' annual reports; national banking regulators

which should help banks cope with any slowing in economic activity and associated rise in problem loans.

In contrast to other Asian countries, Indian banks' non-performing loans rose moderately over 2011, driving an increase in loan-loss provisions and a small reduction in their capital ratio. This has been particularly the case for some state-owned banks; concerns over these banks' asset quality and capitalisation have been reflected in downgrades to their credit ratings. A few state-owned banks in India will receive capital injections from the Indian Government to rebuild their capital positions after recent loan losses.