# Overview

Market concerns about sovereign debt sustainability in Europe have escalated over the past six months and spread to a wider range of countries in that region. Severe market reactions to sovereign credit risk have impinged on funding markets for euro area banks; in particular, US dollar funding pressures have re-emerged in recent months. These funding strains are compounding the difficulties some of these banks already faced from weak economic growth. As a result, a number of euro area banks have become more reliant on central bank liquidity support. Spillovers to bank funding markets outside the euro area have, however, been relatively limited so far.

The sovereign debt problems, together with a reassessment of European and US growth prospects, have raised risk aversion, and helped trigger a period of heightened turbulence in global financial markets since early August. Associated with this, share prices of financial institutions have fallen sharply in most major markets, but particularly in the euro area. While the latest market strains have not been on the same scale as 2008–09, it is difficult to tell at this stage whether this will be another temporary bout of market uncertainty, of the kind seen several times in the past few years, or the beginning of a more serious market dislocation. Much will depend on the ability of governments, especially in Europe, to resolve the sovereign debt problems affecting some countries.

Compared with the pre-crisis period, the major banking systems should be better positioned to cope with a period of renewed market stress. Most large banks in the major advanced countries have strengthened their capital and funding positions over recent years. While banks in Europe are carrying significant aggregate exposures to debt of the sovereigns whose creditworthiness has declined, there is less uncertainty about problem exposures than there was during the 2008 crisis. This is partly because sovereign bonds are less complex than the structured securities that sparked the crisis, and partly because recent supervisory stress test results provided detailed data to markets about those exposures. These differences should help to limit any contagion effects compared with those seen during 2008–09.

Most large banks have continued to report profits in the recent period, though overall returns on equity remain below pre-crisis averages. Many banks are, however, still dealing with elevated levels of non-performing loans, particularly property-related loans, and their loan-loss provisioning is no longer declining rapidly from the peaks seen during the crisis. The difficult macro-financial environment in the major economies will continue to affect the outlook for banks' asset quality and profitability.

The Australian banking system remains in a relatively strong condition compared with some overseas. The recent global market turbulence has contributed to falls in Australian banks' share prices and some tightening in wholesale funding conditions, but the overall effect has been modest compared with the experience in 2008–09 or with some other countries currently. The Australian banking system is considerably better placed to cope with periods of market strain than it was before the crisis, having substantially strengthened its liquidity, funding and capital positions in recent years. Growth in bank deposits is continuing to outpace growth in credit, and the major banks are ahead of schedule on their term wholesale funding plans. Profitability for the major banks has continued to increase to around pre-crisis levels, mainly due to further declines in charges for bad and doubtful debts. However, the scope for banks' domestic balance sheets to expand is likely to be more limited than in the years preceding the crisis, given the more cautious approach of the household and business sectors towards leverage. Banks and their shareholders may therefore need to adjust their return expectations to be consistent with an environment of slower credit growth.

Despite the relatively favourable macroeconomic environment and low level of unemployment, the ratio of Australian banks' non-performing assets to total assets remains close to its recent peak, though it is well below the levels seen in the early 1990s and those currently experienced in many other developed countries. Business loans still account for the bulk of banks' non-performing loans, but there has been some reduction in these recently. In contrast, the non-performing share of banks' housing loans has drifted higher since late 2010. The bulk of non-performing housing loans are well collateralised and therefore not likely to lead to material losses.

The insurance industry in Australia has coped well with the elevated levels of claims from the natural disasters at the start of 2011, assisted by robust reinsurance arrangements. Profits of these firms declined in the March quarter, but have since recovered. However, their costs of reinsurance have risen, and at least some of the increase is already being passed on to customers.

The household sector in Australia is continuing to exhibit a more cautious approach to its spending and borrowing behaviour than prior to the crisis. The household saving rate increased further over the past year and debt has continued to grow at a rate broadly in line with income growth. This relative caution may partly be motivated by recent volatility in households' net asset position following a long period of rapid expansion. Around half of mortgage borrowers are continuing to make substantial excess principal repayments, which is improving their resilience to any change in financial conditions. Even so, household indebtedness remains quite high, as does the aggregate debt-servicing ratio, though both are below their recent peaks. While the mortgage arrears rate drifted up over the first half of the year, it nonetheless remains at a low level by international standards and in absolute terms. The rise has mainly related to loans taken out prior to 2009, when banks' lending standards were weaker; newer loans are performing well despite the increase in interest rates over the past couple of years.

The business sector is also experiencing mixed conditions: mining and related sectors continue to benefit from the resources boom, while other sectors, including retail, are facing pressures from subdued domestic household spending and the high exchange rate. Sectoral measures of profits and business confidence have therefore diverged. Having deleveraged considerably, the business sector is in a stronger financial position overall than it was several years ago. Businesses' demand for external funding remains weak. This is partly because the business sector has been able to finance a larger share of its investment through internal funding in recent years, as much of that investment has been concentrated in sectors such as mining, where profitability has increased the most.

Regarding financial regulatory issues, national authorities are in the process of deciding how best to implement the Basel III bank capital and liquidity reforms. The Australian Prudential Regulation Authority (APRA) recently published a consultative document on how it intends to implement the Basel III capital reforms in Australia. Given that the Australian banking sector has already substantially bolstered its capital position in recent years, it is well placed to meet the new standards. APRA has therefore proposed a faster timetable for adoption of the new global minimum capital standards than required under the Basel III rules.

Meanwhile, the international regulatory reform agenda has recently been focused on developing a policy framework to address the risks posed by systemically important financial institutions (SIFIs). Agreement is close to being finalised on a methodology to identify banks that are systemically important in a global context, along with the level and form of additional capital that these institutions will be required to hold above the Basel III requirements. Another aspect of this work has been the development of a set of principles on effective resolution regimes for SIFIs, which are intended to enhance authorities' ability to resolve distressed SIFIs without disrupting the wider financial system or exposing taxpayers to losses. There has also been progress over the past six months on a number of other international regulatory initiatives, including the move towards central clearing of over-the-counter derivatives and developing policy frameworks to address the risks posed by shadow banks. Australia continues to be an active participant in the various international discussions that are shaping these reforms.

Domestically, the Australian Government recently introduced legislation into Parliament that would permit deposit-taking institutions to issue covered bonds. It has also announced the permanent arrangements to be put in place for the Financial Claims Scheme, following a review by the Council of Financial Regulators (CFR) of how the Scheme should be configured in a post-crisis environment. More recently, the CFR has been examining a number of issues related to the regulation and crisis management arrangements for financial market infrastructures in Australia.