Overview

In the period since the previous *Financial Stability Review*, global financial conditions have evolved in two distinct phases. The sovereign debt problems in the euro area escalated over the second half of 2011 as market concerns about debt sustainability intensified in a wider group of countries. Reflecting the links between sovereign and bank balance sheets, bank funding markets in the euro area came under intense strain, triggering fears of a bank liquidity crisis in the region. The turmoil spread to global financial markets, leading to tighter wholesale funding conditions for banks in many countries, including Australia.

Global market sentiment has improved noticeably since late December. To a large extent, this reflected the European Central Bank's (ECB's) three-year lending operations, which have greatly reduced funding risks for European banks. There has also been gradual progress towards enhancing euro area fiscal governance and dealing with Greece's sovereign debt problems. In addition, recent economic data in the United States have been more positive, somewhat allaying fears about a global growth slump. Accordingly, sovereign bond yields in Europe have declined from their recent peaks and equity markets have rallied globally. Bank share prices have increased in line with broader market movements, although in some cases they remain below levels seen in mid 2011. Pressures in bank funding markets have eased, but spreads are still fairly high.

Even though conditions in financial markets have improved, the ongoing difficulties in Europe as well as the subdued outlook for global growth will continue to pose risks to global financial stability in the period ahead. Bank lending conditions tightened noticeably in several euro area countries in late 2011 and economic conditions weakened. These developments posed the risk of an adverse feedback loop between economic conditions, fiscal balances, borrower creditworthiness and banks' balance sheets, although policy actions by the ECB have alleviated that risk, at least for the time being.

While the immediate funding pressures on euro area banks have eased, some still need to improve their funding structures and capital positions, and are responding by continuing to shrink their balance sheets. This process is having adverse spillovers on some emerging market countries where euro area banks are active. The effects have been less apparent in Asia, given that the euro area banks have a relatively small presence there and the local banking systems are in reasonably good shape.

Countries outside the euro area remain susceptible to developments in Europe, and some are also dealing with their own financial sector vulnerabilities. In particular, property markets remain weak and levels of non-performing loans elevated in some large advanced countries, including the United States. In Asia, credit and asset prices have been growing strongly in a few countries over recent years, prompting authorities to tighten prudential policies. While non-performing loans are currently at low levels across the region, a decline in asset prices or significant slowing in economic activity could expose credit quality problems.

The Australian banking system remains in a relatively strong condition. The larger banks are in a better position than a few years ago to cope with the tighter funding conditions given the improvements they have made to their funding, liquidity and capital positions over recent years. Their wholesale funding task is also more manageable, with deposit growth continuing to outpace growth in credit by a wide margin. The improved conditions in global bank funding markets this year have enabled the larger banks to significantly step up their bond issuance, including through their newly established covered bond programs. Bond spreads remain wider than in the middle of last year, though, which has resulted in some loan repricing recently.

Banks' non-performing asset levels have come down a little recently, but remain higher than they were a few years ago, particularly for business loans. The overall loan impairment rate is still well below the levels seen in the early 1990s, and also below those currently experienced in many other developed economies. Exposures to the euro area, particularly to the countries experiencing the greatest financial stress, remain very low. The large banks have continued to record robust profits, generating returns on equity that have been broadly in line with long-run averages. However, the slow credit growth environment could constrain the pace of their future profit growth. It would therefore be unhelpful if banks were to chase unrealistic profit expectations by taking on more risk – through lowering credit standards or expanding too quickly into new or unfamiliar markets – or by pursuing cost cutting in a way that weakens their risk management capabilities.

The general insurance industry in Australia has coped well with the difficult underwriting and investment conditions of the past year and a half. While industry profits have been subdued recently, the industry remains well capitalised and backed by robust reinsurance arrangements.

The household sector has continued to show a more cautious approach towards its finances in recent years, which is helping to improve its resilience to possible shocks. The household saving rate has averaged around 9½ per cent; there has been a shift towards more conservative investment allocations; and many households are choosing to repay their debt more quickly than required. Part of the motivation for a higher saving rate may have been a desire to bolster wealth, given the weakness in some asset markets in recent years. Growth in household income has exceeded growth in debt for the past few years. This has also been helping to underpin households' debt-servicing capacity. Accordingly, aggregate measures of household financial stress remain low, though mortgage arrears rates are still somewhat higher than a few years ago.

Conditions continue to vary significantly across the business sector: the mining and related sectors are benefiting from the resources boom, while the retail, manufacturing, construction and tourism sectors are facing headwinds from subdued retail spending and the high exchange rate. These divergent experiences help explain why banks' non-performing business loans and business failure rates are somewhat higher than average. Overall, though, the business sector is in a better financial position than it was several years ago, having delevered considerably and improved its liquidity position. Though business credit has picked up a little recently, overall demand for external funding remains subdued. The parts of the business sector where investment has been strongest, such as mining, have also experienced the greatest increases in profitability in recent years, which has allowed them to finance a larger part of their investment from internal sources. The commercial property market, traditionally a source of vulnerability for banks, has continued to improve after the recent downturn, although construction activity is still muted and financing activity weak.

The international regulatory reform effort has continued over the past six months. Agreement was recently reached on an integrated policy framework to address the risks posed by systemically important financial institutions (SIFIs), with the focus initially being on the large global banks. The framework includes higher capital requirements for these banks as well as improved resolution regimes. Work is underway to extend this framework to other SIFIs, including banks that are systemically important in a domestic context. 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 (OTC) derivatives and strengthening the oversight and regulation of shadow banks. Australia continues to be an active participant in the international discussions that are shaping these various reforms.

Domestically, the Australian Prudential Regulation Authority has been engaged with authorised deposit-taking institutions on the implementation of the Basel III capital and liquidity reforms, which will be phased in over the coming years. The Reserve Bank recently published details of the Committed Liquidity Facility that it will provide as part of Australia's implementation of the liquidity reforms. The Council of Financial Regulators has been reviewing aspects of the domestic regulatory arrangements for financial market infrastructures and OTC derivatives. Australia will this year be undergoing an independent review by the International Monetary Fund under its Financial Sector Assessment Program, which will involve a comprehensive assessment of the stability of the financial system and the quality of the financial supervisory and crisis management arrangements.