Overview

The period since the last *Financial Stability Review* has seen further recovery in the global financial system from the extreme dislocation experienced in late 2008 and early 2009. Prospects for growth of the world economy have picked up, and conditions in a number of asset markets have improved, though performance has varied widely across countries. The improved environment has enabled a number of countries to wind back some of the extraordinary support measures that were put in place at the height of the crisis. However, significant challenges and uncertainties for the global financial system remain.

Confidence in financial markets has recently been affected by concerns about sovereign credit risk, particularly in Europe. Nonetheless, over the past six months, risk pricing in financial markets has generally moderated, and bank funding conditions have improved.

In the large advanced economies, the major banks have broadly returned to a position of modest profitability after a period of significant losses. The recent pick-up in bank profitability has owed significantly to the passing of one-off securities write-downs which were concentrated mainly in 2008. However, losses arising from banks' on-balance sheet lending remain high, and are likely to weigh on profits for some time. This is contributing to tight credit supply, and the interaction between conditions in the financial and real sectors in these economies remains an area of ongoing risk.

In contrast, conditions in the Asian region (outside Japan) are much more buoyant. The effects of the global crisis on financial sectors in the region were less severe than in the North Atlantic countries, and confidence across the region has been recovering as economic growth has picked up. There has been a marked turnaround in capital flows to the region, and attention in a number of these economies is now focused on rising inflationary pressures. In China and India this situation has prompted recent measures to tighten monetary conditions.

The Australian financial system remained resilient through the crisis period and, in aggregate, banks experienced only a relatively shallow downturn in underlying profits. The quality of banks' housing loan portfolios has proven to be very high by international standards, notwithstanding a modest increase in loan arrears. There has been a more significant deterioration in the quality of banks' business loan portfolios, particularly for commercial property, and this remains an area to watch closely in the period ahead. Nonetheless, recent indications are that banks' overall loan losses may have peaked and that profits have again begun to increase. While the regional and foreign-owned banks experienced a somewhat larger deterioration in performance during the downturn than did the majors, the more recent improvement has been broadly based across all categories of banks.

Funding conditions for Australian banking institutions have continued to improve since the time of the last *Review*. Demand for new issuance of residential mortgage-backed securities has been strengthening, and this should assist smaller lenders in funding their loans in the period ahead. Spreads in wholesale markets more generally have narrowed further, though they remain higher than pre-crisis levels. Banks have experienced improved access to offshore funding markets, and the general narrowing of risk spreads has increased the relative attractiveness of issuing in the unguaranteed market. As a result, the banks had substantially reduced their use of the wholesale funding guarantee by early 2010.

In these circumstances, the Government announced in February that the guarantee scheme would be closed to new issuance after 31 March 2010, acting on advice from the Council of Financial Regulators that the scheme was no longer needed. A number of other countries including the United States, France and the United Kingdom have also moved recently to close their wholesale guarantee schemes. Given that Australian banks had already wound back their issuance of guaranteed liabilities in response to movements in market pricing, the removal of the wholesale guarantee is not expected to have a material impact on their overall funding costs.

The household and business sectors in Australia are benefitting from improved economic conditions. Household incomes have continued to grow solidly over the past couple of years, partly reflecting the impact of policy measures taken during the economic slowdown and, more recently, stronger employment growth. While households have generally been more cautious in their borrowing behaviour than in the pre-crisis period, their demand for housing credit strengthened noticeably during 2009, and this has been associated with stronger growth in housing prices. In recent months, however, higher interest rates appear to have had a dampening effect on housing finance. Unlike households, Australian businesses have undertaken significant deleveraging over the past couple of years. This has been partly induced by tighter credit supply conditions, but has also reflected efforts by businesses to strengthen their balance sheets by raising additional equity and reducing debt. There are signs that this deleveraging process may now be drawing to a close, with business credit having begun to stabilise over recent months and indications that credit supply conditions for the business sector are becoming less restrictive.

Overall, the domestic financial and non-financial sectors have performed relatively well over the past couple of years during what has been an extremely difficult period internationally. With the world economy now recovering, financial risks appear to be abating. Nevertheless, market sentiment in the major advanced economies remains fragile, and vulnerable to the possibility that further bad news could trigger a renewed heightening of risk aversion. The situation in the Asian region is very different, with the main risks at present being those associated not with risk aversion, but with rapid credit growth and rising asset prices.

Considerable work is underway within various international bodies, including the G-20, the Financial Stability Board, and the Basel Committee on Banking Supervision (BCBS), to review the financial regulatory structure in light of the lessons from recent experience. The key elements of proposed reforms include measures to strengthen bank capital and liquidity requirements and to improve accounting standards, along with a range of other measures aimed at reducing systemic risk. The BCBS is currently conducting an extensive quantitative impact study of the main proposals and is due to finalise its revised capital and liquidity standards by the end of the year. Australia is an active participant in these international bodies, and the Reserve Bank is co-ordinating closely with other domestic agencies in considering Australia's response to these international regulatory developments.