Overview

In the period since the previous *Financial Stability Review* the health of the major international banks has mostly improved, despite a significant amount of uncertainty in financial markets. In aggregate, loan losses of banks in the major economies have fallen, and banks have recorded improvements in profitability after the heavy losses incurred in 2008 and the first half of 2009.

While these developments have been encouraging, there remain important areas of uncertainty in global markets. During April and May, markets focused on concerns about euro area sovereign debt, and the potential for negative feedbacks through credit and funding markets. Financial prices reflected these concerns, with bank share prices generally declining at that time and risk spreads widening in a number of European markets. Subsequently, investor confidence was assisted by the European support packages and bank stress tests, though some country-specific concerns within the euro area have recently re-emerged. These events have influenced markets outside Europe and there have been periods of renewed nervousness in international funding markets.

In contrast to the North Atlantic region, financial conditions in the fast-growing Asian and Latin American economies have generally been quite buoyant over the recent period. As confidence returned in the post-crisis environment, these economies have experienced high rates of capital inflow along with strong conditions in their domestic credit and asset markets. In a number of cases, including China, this prompted policy actions to dampen credit growth and discourage excessive risk-taking in property markets.

The Australian financial system remains in relatively strong condition, as does the broader economy. The effects of the global crisis on the Australian economy and financial system were quite mild, and economic growth has now broadly returned to trend. This performance reflects several factors including the greater scope that existed for macroeconomic policy action in Australia to moderate the impact of the crisis, the comparatively strong balance sheets of the domestic banks in the period leading into the crisis, and the high exposure of the Australian economy to trade with the Asian region.

Indicators of the financial strength of Australian banks have generally continued to improve recently. In aggregate, Australia's banking system remained profitable during the crisis period, and profits have increased further in the latest half year. The flow of bad debt charges has generally peaked, while the stock of non-performing assets on banks' balance sheets appears to be stabilising at a level that remains low in comparison with previous cyclical experience. Loan impairments and losses have been concentrated mainly in lending to businesses, particularly for commercial property. There has been some upward drift in arrears rates on the housing portfolio, though these remain fairly low overall.

In the crisis-affected environment, Australian banks took significant actions to strengthen their balance sheets by raising new capital and through ongoing dividend reinvestment. In addition to strengthening their capital positions, banks have moved to increase the robustness of their liquidity positions by lengthening the term structure of their wholesale liabilities and increasing the share of funding from deposits. These moves should assist banks' ability to withstand periods of difficulty in global funding markets.

The financial position of the household and business sectors in Australia remains sound. Household incomes have been growing at a solid pace and unemployment has been declining. Households continue to exhibit a somewhat more cautious approach to debt than prior to the crisis, with welcome signs that the recent housing market strength led by first-home buyers has cooled. Notwithstanding recent cyclical variations, housing prices have shown little net change as a ratio to incomes over several years, following an earlier structural increase in this ratio associated with financial deregulation and the shift to a low inflation environment. Within the national housing market, there has been some significant regional variation, with market conditions particularly strong recently in Victoria.

In the business sector, there has been considerable deleveraging in the post-crisis period, bringing average debt-to-equity and interest-payment ratios to levels close to their lowest in three decades. Businesses have made use of both new equity issuance and strong internal funding during this process. While this shift in business funding was in part demand-driven, there was also a notable tightening of supply in 2008 and 2009; the availability of debt funding to businesses now appears to be improving, though credit availability for some sectors, including commercial property, remains quite constrained.

In summary, conditions in the global financial system have improved in a number of respects over the past half year, but significant uncertainties remain and there are important differences in conditions across the global economic regions. In the fast-growing economies of Asia and elsewhere, economic recoveries have been rapid and the focus of financial risk management is most likely to be on avoiding the problems of excessive buoyancy; in the North Atlantic region, economic and financial recoveries have to date been more hesitant, and the focus will remain on the resilience of recoveries to the withdrawal of policy stimulus. Australia's financial system, while not immune to swings in sentiment affecting global markets, has come through the disruptions to date in relatively good shape.

International work on financial regulatory reform is continuing through bodies including the Financial Stability Board and the Basel Committee on Banking Supervision (BCBS). A package of reforms designed to strengthen capital and liquidity standards in the global banking system is scheduled to be completed later in the year. Agreements on a number of elements of the package have already been announced. The general approach being adopted in the international arena is to aim for robust standards while allowing sufficient transition time to ensure that implementation is not unnecessarily disruptive. Australian banks are well placed to meet the proposed new capital standards, but application of the proposed new liquidity standard in Australia is not straightforward given the low levels of domestic government debt for banks to hold as liquid assets; the BCBS will incorporate scope for alternative arrangements in jurisdictions where this is the case. Australia continues to play an active part in these international bodies, and the Reserve Bank is co-ordinating closely with other domestic agencies in helping to shape these international regulatory developments.