Overview

Over the past three years or so, concerns about financial instability have been focused primarily on vulnerabilities generated within the banking sector, particularly in the major economies. Recent natural disasters in Australia, New Zealand and Japan, as well as the unrest in North Africa and the Middle East, have redirected some attention to the resilience of the financial system to shocks from outside it. Information available to date suggests that the costs to Australian insurers of the recent disasters are within the sector's capacity to absorb them. For global insurers, the financial effects of the Japanese earthquake and tsunami are likely to be more severe, but will take some time to evaluate.

Confidence in the banking systems of major countries has generally improved since the previous *Financial Stability Review*. Bank share prices in the major markets tended to increase over much of this period, along with broader market moves, though they have moderated in recent weeks reflecting the natural disasters and tensions in North Africa and the Middle East. The major international banks have continued to report profits and strengthen their balance sheets. Some banking systems are still under considerable strain, however, notably in parts of Europe, where recovery is being undermined by market concerns about sovereign debt sustainability.

In the major economies, banks' profits have recently been supported by generally improving economic conditions. This has allowed them to reduce loan loss provisions, offsetting some moderation in trading and investment income. However, the underlying revenue growth of many banks remains subdued, as credit growth is still quite weak. The return to profitability since the crisis has helped banks to strengthen their capital positions, and some have also been able to repay the public capital that was injected into them during the crisis. While this places banks in a better position to withstand future shocks, some of them will probably need to repair their balance sheets further.

Banks globally face a number of challenges in the period ahead. Despite the recent reductions in loan loss provisions, non-performing asset ratios remain high in many banking systems, particularly those that are dealing with a large amount of troubled property-related exposures. The continued dislocations in property markets, and the likelihood of slow and uneven economic recovery in some major economies, will weigh on banks' asset quality and profitability. There are also concerns about how some countries' banking systems will cope with the withdrawal of macroeconomic policy stimulus. Bank wholesale funding markets have generally been stable over the past six months, despite the focus on sovereign risk in Europe. However, funding will remain a challenge for many banks over the next few years, as they need to improve their funding structures at the same time as refinancing government-guaranteed debt issued during the crisis. Hence they remain susceptible to any sudden turns in market sentiment.

Some of the fast-growing emerging market economies are facing a different set of financial stability challenges. They face a combination of strong economic growth, still-expansionary macroeconomic policy, and in some cases managed exchange rates, which is contributing to rapid credit and asset price growth. Some have already taken policy actions in response, though further action may be needed to prevent a build-up of financial and economic imbalances in these countries.

The Australian banking system has continued to perform better than those in many other countries, consistent with the relative strength of the domestic economy over recent years. Non-performing asset levels remain higher than a few years ago, though they are low in comparison with those in the major economies. Their largest component – non-performing business loans – was beginning to show slight signs of improvement towards the end of last year, and the flow of loan loss provisions has already fallen significantly. For the largest banks, profitability has now recovered to near pre-crisis levels. Profitability has also picked up for the smaller Australian-owned banks, though the increase has been less pronounced, reflecting their somewhat weaker asset quality. The flooding and other recent natural disasters are unlikely to have a major effect on banks' asset quality. However, they will result in a significant increase in claims on general insurers, which will reduce their profits in the current financial year.

Australian banks have maintained ready access to wholesale funding markets in the past six months, but they have also had less need to raise wholesale funds over this period as growth in deposits continues to outpace growth in credit. This shift towards deposit funding has enabled banks to further reduce their reliance on short-term wholesale debt. As a result, their liquidity positions have improved further. Banks' capital positions have also been substantially bolstered in recent years.

The economic expansion is supporting the financial position of the household and business sectors in Australia. They nonetheless continue to exhibit a more cautious approach to their borrowing than prior to the crisis, with businesses deleveraging significantly and households reducing the growth in their debt outstanding to a rate more in line with income growth. Household indebtedness remains historically high, however, and recent increases in interest rates have lifted the aggregate debt-servicing requirement. While indicators of financial stress are relatively subdued, a continuation of this recent borrowing restraint would help build additional resilience into households' balance sheets.

As the global economy moves beyond the initial recovery phase, the challenge for financial institutions and regulators in Australia will be to manage an expansion under post-crisis conditions. The very rapid growth in the financial system over the years that preceded the crisis seems unlikely to be repeated, since to a significant degree it represented a one-time adjustment to financial deregulation and the shift to low inflation. If that view is correct, then banks' domestic growth opportunities will be more limited in the years ahead. There is no reason why the financial system cannot adapt smoothly to a slower rate of expansion, but if industry participants were to attempt to return to their earlier rates of growth, they could be induced to take risks that may subsequently be difficult to manage. Maintaining a more moderate pace of balance sheet expansion, particularly one that is more easily able to be funded by deposits, will also assist in further strengthening bank funding profiles.

Another issue for both the Australian and global financial sectors over the coming years will be dealing with significant changes in the regulatory environment. International agreement was reached late last year on the main elements of the global bank capital and liquidity reforms known as Basel III, which are to be phased in over the next decade or so. In recent months, the focus has been on finalising the details of the agreed reforms for banks and how they can best be implemented across countries. Australian banks are well placed to meet the new capital standards, particularly given the significant bolstering of their capital positions in recent years. Since the previous *Review*, international agreement has also been reached on alternative arrangements for countries such as Australia where there are insufficient government securities for banks to hold to comply with the new liquidity standards. The Reserve Bank of Australia (RBA) and Australian Prudential Regulation Authority have announced the approach that will be adopted here, which involves allowing banks to establish contractual committed liquidity facilities with the RBA. This will ensure Australian banks meet the standards while giving them the same incentives as banks in other jurisdictions to manage their liquidity positions prudently.

Other areas of importance in recent months have been the continuing work at the international level on identifying financial institutions that are systemic in a global context and ways to strengthen their capacity to absorb losses, and the move towards central clearing of over-the-counter derivatives. There is also work ongoing at the global level to strengthen the intensity and effectiveness of supervision, which is a necessary complement to the new regulations. Australia continues to be an active participant in the international discussions that are shaping these reforms. ✠