

The Global Financial Environment

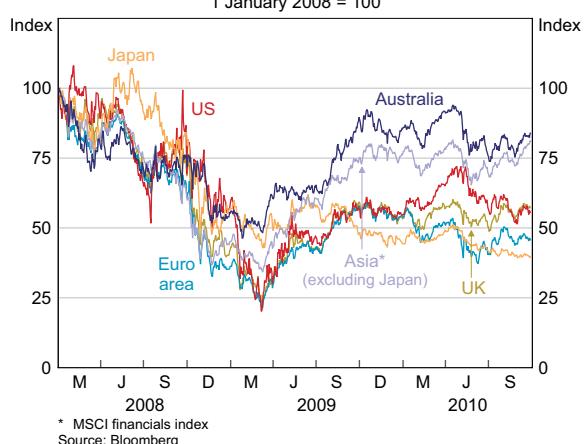
The past six months have seen some further improvement in recorded profitability in major countries' banking systems. Banks' share prices are, however, generally lower over the period, reflecting falls in April and May on concerns about peripheral euro area sovereign debt and the potential for negative feedback through credit exposures and funding markets. Investor sentiment was bolstered by the European support packages and bank stress tests, but subsequent softer data in some major economies raised concerns about whether the economic recovery that has supported loan quality would be robust to the withdrawal of extreme monetary and fiscal stimulus measures.

Profitability and Capital

Bank share price indices have generally fallen a little since end March, along with broader share price indices (Graph 1). The main downward movement was associated with the euro area sovereign debt concerns that flared in April and May, focusing on Greece, Portugal and Spain, discussed further in the section on 'Wholesale Funding Markets and Credit'. In particular, attention centred on banking systems in those countries – given the potential for contagion through funding markets, confidence and the economy – and on banks with direct exposures to debt issued by those governments.

As in earlier bouts of financial instability, authorities acted to calm sentiment. Support packages backed by the European Union (EU), euro area governments and the International Monetary Fund made significant financial assistance available for Greece

Graph 1
Banks' Share Prices
1 January 2008 = 100

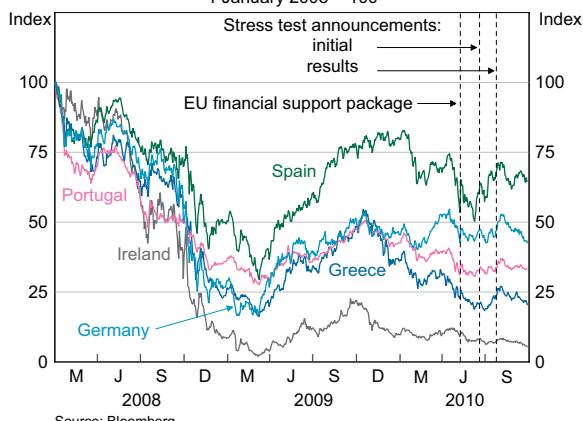


and any other troubled European sovereigns, and the EU banking sector stress test exercise reassured investors that most banks would be resilient to further economic deterioration. Although euro area bank share prices have recovered somewhat, they remain among the weakest of the major economies: the euro area index is more than 50 per cent below early 2008 levels, with indices in countries such as Ireland, Greece and Portugal significantly lower again (Graph 2).

Despite the movement in bank share price indices over the past six months, reported profitability of banking systems in the major developed countries has generally continued to improve. Many large banks in the United States, euro area, United Kingdom and Japan have sustained profits for a run of recent reporting periods, helping

Graph 2 Euro Area Banks' Share Prices

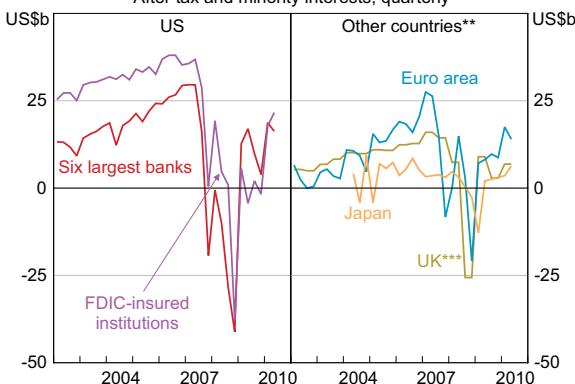
1 January 2008 = 100



Source: Bloomberg

Graph 3 Banks' Profits*

After tax and minority interests, quarterly



* Adjusted for significant mergers and acquisitions

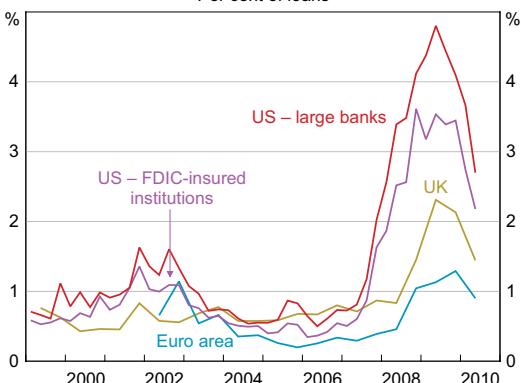
** Ten largest euro area banks (including Switzerland), five largest UK banks and four largest Japanese banks

*** Implied from semi-annual data

Sources: Bloomberg; FDIC; banks' annual and interim reports

Graph 4 Banks' Loan Loss Provisioning*

Per cent of loans



* Adjusted for significant mergers and acquisitions; annualised values of quarterly or semi-annual provisions; not seasonally adjusted; six largest US banks, ten largest euro area banks (including Switzerland) and five largest UK banks

Sources: Bloomberg; FDIC; banks' annual and interim reports

to rebuild capital after the heavy losses at the height of the crisis (Graph 3). In non-Japan Asia, banking systems had largely avoided the securities write-downs that were so damaging for many large North Atlantic banks, and profits have lifted further with the relatively strong macroeconomic outcomes.

The main factor boosting bank profitability in the major countries in the recent period has been the decline in the flow of provisions for bad loans as economic conditions have improved. In the United States, provisions have declined over the past year, particularly for larger institutions (Graph 4). In the United Kingdom, provisions have also fallen over the past year, most sharply in the half year to June. Aggregate falls in provisions have been a more recent development at large euro area banks although their provisions had generally been much lower. For larger banks, profits have also been supported by strong trading and investment income since the height of the crisis, though this has eased in some of the most recent results.

Reflecting differing economic and financial conditions, however, there is considerable variation in banking system performance by country, even in relatively integrated regions such as Europe. In particular, current and expected profits for banking systems in Greece, Portugal and Spain have been negatively affected by the recent sovereign debt concerns in these countries, and the associated effects on the economy, loan quality and funding conditions (see 'Box A: Banking Systems in Greece, Portugal and Spain'). Irish banks remain particularly challenged, with the largest banks generally reporting further losses in the first half of 2010, as they have done since 2008. The ongoing weakness in the banking sector, and the related increase in fiscal support costs, have recently aggravated concerns about Irish sovereign debt.

Just as developments in bank profitability and provisions have varied widely by country, there has been considerable variation within banking systems. There is evidence of the fall in provisions and return to profitability broadening across some of the banking systems most affected by the crisis:

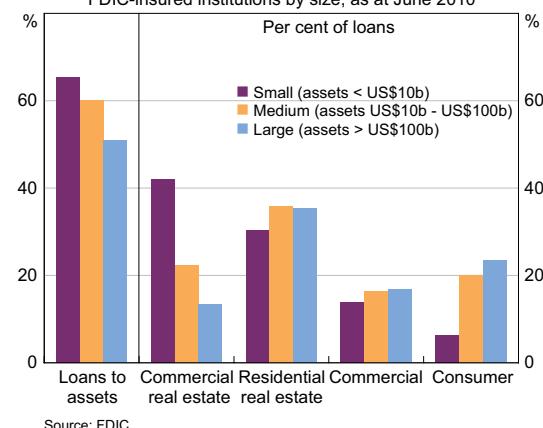
in the half year to June in the United States, both small and medium-sized Federal Deposit Insurance Corporation (FDIC) insured institutions – which each account for around 20 per cent of total FDIC-insured assets – recorded an aggregate half-yearly profit for the first time in nearly two years. Vulnerability remains for many US banks, however, particularly among the smaller institutions that, in aggregate, have a relatively high share of assets exposed to the troubled commercial property sector (Graph 5). To date in 2010, 127 mainly small institutions have failed, well ahead of the number at the same time last year, and over 10 per cent of banks by number are considered vulnerable by the FDIC, more than the 1990s peak (Graph 6). Within countries in the euro area, more challenged segments are also evident with, for example, the state-owned German Landesbanken and the Spanish cajas (savings banks) generally performing worse than commercial banks in those countries.

Improved profitability in the major countries' banking systems is helping to support their capital positions. Banks have generally been looking to increase capital in the wake of the crisis as markets, rating agencies and regulators have reappraised appropriate levels and forms of capital, as discussed further in the chapter on 'Developments in the Financial System Architecture'. After some large market capital raisings in 2009, recent increases have relied more on retained earnings, as profits have picked up and dividends have remained low relative to earnings, in some cases reflecting conditions attached to earlier public equity injections.

In the United States, a number of mainly larger banks have repaid public capital: over 80 of the 707 institutions receiving Troubled Asset Relief Program funds through the Capital Purchase Program have repaid the US Treasury in full, accounting for around 72 per cent of the total amount extended under this package. Some institutions have facilitated repayment of public capital by raising capital from the private sector, but this option is generally more difficult for smaller institutions, about one half of which are unlisted.

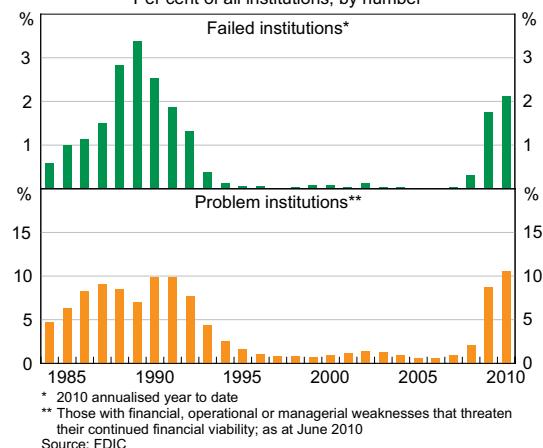
Graph 5
US Banks' Loans

FDIC-insured institutions by size, as at June 2010



Graph 6
FDIC-insured Institutions in Difficulty

Per cent of all institutions, by number



There has been less repayment of public capital in the euro area. Given the nervousness about sovereign debt in some euro area countries and the potential for this to weaken banking sectors, new arrangements to facilitate further public capital injections, if required, have been established and others maintained or extended. These include individual country schemes to support banks in Greece, Spain and Germany, and the euro area-wide European Financial Stability Facility to support sovereigns.

These capital support arrangements were an important backstop to the EU banking sector stress test exercise, completed in July, which tested the capital resilience of 91 EU banks to an adverse economic and financial scenario. Ultimately, these banks were reported to be more resilient to the scenario than the market had expected. Some analysts had been expecting up to 20 banks to fall short of the 6 per cent Tier 1 capital ratio benchmark set for the exercise, by an aggregate amount of between €30 billion and €90 billion. In the event, just seven banks – from Spain, Germany and Greece – came in below the benchmark for a combined shortfall of €3.5 billion, though another 17 were within one percentage point of the benchmark (Table 1). It is notable that the participating banks' capital already incorporated around €200 billion of public capital provided earlier in the crisis.

Significant public injections of capital remain in place for the financial system outside of the banking sector, particularly for parts of the US financial system affected by significant housing market losses. The Government-sponsored housing agencies have required regular injections of public capital to offset significant ongoing losses, such that the cumulative public capital injections into Fannie Mae and Freddie Mac now total US\$150 billion, with official estimates

that this could rise further. The insurer AIG, which has considerable public funding still in place, has also continued to report losses in the year to June. Difficult conditions also persist for insurance market segments with housing exposure such as US lenders' mortgage insurers and US monoline insurers. Operating losses have generally continued for these industries in the first half of 2010, and share prices for the three largest insurers in each segment are, in aggregate, 90 per cent or more below their levels in early 2007.

More broadly, general insurers in the United States and Europe – like banks – typically maintained their profitability in the first half of 2010, despite pressures on premiums. Market sentiment towards insurers has moved similarly to banks, with a mild fall in share prices and an increase in credit default premiums over the past six months (Graph 7). Reinsurers' profits have been dampened by natural disasters, though a turnaround in investment income has boosted results. For life insurers, low interest rates and compressed margins have weighed on profits. As a result, profits for US and European life insurers have fallen in recent years, with at least one rating agency expecting measured investment losses to continue in the near future.

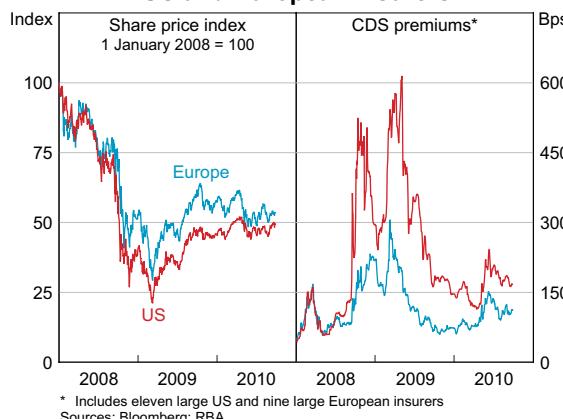
Table 1: EU Stress Test Results by Country

Number of institutions	Number of institutions with a Tier 1 capital ratio in Adverse Scenario ^(a) of:					
	<6%	6 - 6.9%	7 - 7.9%	8 - 8.9%	9 - 9.9%	≥10%
France	4	0	0	0	1	2
Germany	14	1	2	2	4	4
Greece	6	1	1	1	2	0
Ireland	2	0	1	1	0	0
Italy	5	0	2	2	1	0
Portugal	4	0	1	0	2	0
Spain	27	5	9	7	0	2
Other	29	0	1	2	5	5
Total	91	7	17	15	15	24

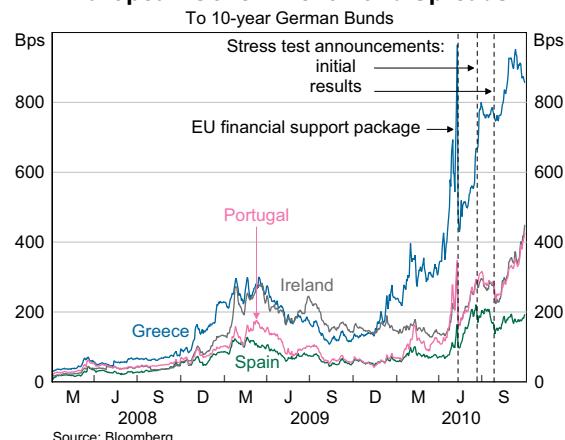
(a) Includes a sovereign risk shock

Source: Committee of European Banking Supervisors

Graph 7
US and European Insurers



Graph 8
European Government Bond Spreads



Wholesale Funding Markets and Credit

Developments in wholesale funding markets over the past six months have been shaped by concerns over sovereign debt in some countries, and the broader issue of the resilience of the global economic recovery to the removal of fiscal and monetary stimulus and financial sector support.

Market nervousness about sovereign debt intensified in early 2010, with a particular focus on Greece, reflecting that it has a relatively high ratio of public debt to GDP, a large budget deficit, and had a significant amount of debt falling due in April and May 2010 (Graph 8).¹ Concerns soon spread more widely, including to other countries with perceived fiscal strains, and to their banking sectors, given the perceived increase in risk from their holdings of sovereign debt, and deteriorating loan quality potentially exacerbated by fiscal consolidation. Sentiment was also affected around this time by the so-called 'flash crash', with US equity markets having a short-lived intraday drop of around 9 per cent in early May, for reasons that are still being investigated.

The fear was that concerns in Greece could trigger a broader financial contagion through intra-European

exposures. Even though foreign banking sector claims on Greece typically amount to less than 1 per cent of total assets, European banks have significant exposures to other European countries where government debt levels have been a recent market focus (Table 2).

In this environment authorities acted to calm sentiment. In May, the EU and the International Monetary Fund announced significant financial support for Greece and, subsequently, euro area governments created the European Financial Stability Facility (EFSF) to assist any other troubled European sovereign. The EFSF can issue bonds guaranteed by participating euro area governments for the purpose of providing support to member countries in difficulty, with guarantee commitments from participating governments totalling €440 billion. Authorities also instigated the EU banking sector stress test exercise (discussed in the section on 'Profitability and Capital') which improved disclosure on banks' sovereign risk exposure and seemed to reassure investors that most banks would be resilient to further economic deterioration. Following these measures, financial market conditions stabilised somewhat, though spreads on European sovereign debt have subsequently widened further for some countries including Greece, Ireland and Portugal.

¹ For further background see Reserve Bank of Australia (2010), 'Box A: Public Finances in Europe', *Statement on Monetary Policy*, August.

Table 2: Foreign Bank Claims on Euro Area Countries^(a)
 Ultimate risk basis, as at 31 March 2010, per cent of lending country's total bank assets^(b)

Reporting banks (by headquarter location)	Greece	Ireland	Italy	Portugal	Spain	Subtotal	Euro area
Euro area banks	0.4	0.8	2.0	0.5	1.5	5.1	12.2
of which:							
German	0.4	1.7	1.8	0.4	2.1	6.5	13.0
French	0.7	0.5	4.5	0.4	1.9	7.8	15.7
Dutch	0.4	0.8	1.9	0.4	3.2	6.7	21.8
Belgian	0.2	2.1	2.1	0.4	1.3	6.1	13.9
Spanish	0.0	0.3	0.8	1.8	–	3.0	5.8
Portuguese	1.6	2.6	0.7	–	3.8	8.8	13.0
Swiss banks	0.2	0.8	0.7	0.1	0.6	2.4	12.8
UK banks	0.1	1.5	0.6	0.2	1.0	3.5	10.0
US banks	0.1	0.4	0.3	0.0	0.4	1.2	5.1
Japanese banks	0.1	0.2	0.5	0.0	0.3	1.2	5.4
Australian banks	0.0	0.2	0.4	0.0	0.1	0.7	2.0

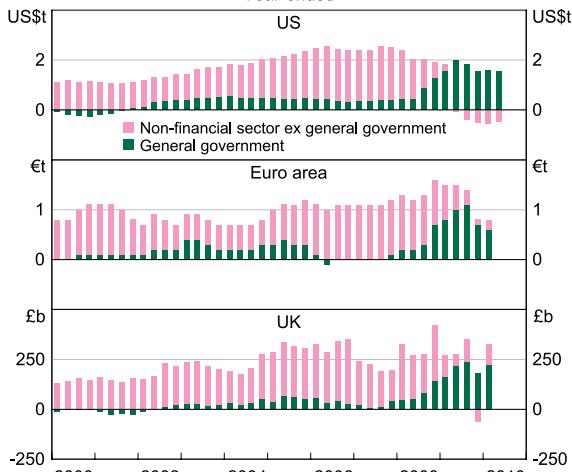
(a) Based on 24 countries reporting to the BIS

(b) Monetary financial institutions used as a proxy for total bank assets for countries in the euro area and the United Kingdom

Sources: BIS; RBA; Thomson Reuters; central banks

Graph 9 Domestic Non-financial Debt Flows

Year-ended



Sources: Board of Governors of the Federal Reserve System; Eurostat;
 Office for National Statistics

Though sovereign debt fears have focused on the euro area, there are broader concerns about the need for medium-term fiscal consolidation in a number of countries, at a time when the resilience of economies to the withdrawal of fiscal stimulus is in question. One indication of the support being provided by fiscal policy is that, in the major economies, general government borrowing has accounted for almost all financing activity over the past year; households and businesses have barely borrowed in net terms (Graph 9).

Private financing activity in these countries is weak despite monetary policy remaining very accommodative. Cash rates are effectively zero in a number of the major markets, and long-term rates in many countries are around multi-year lows: for example, German Bund yields are currently around the lowest level since at least the 1920s. Low long-term rates partly reflect risk aversion among investors, but also that a number of central

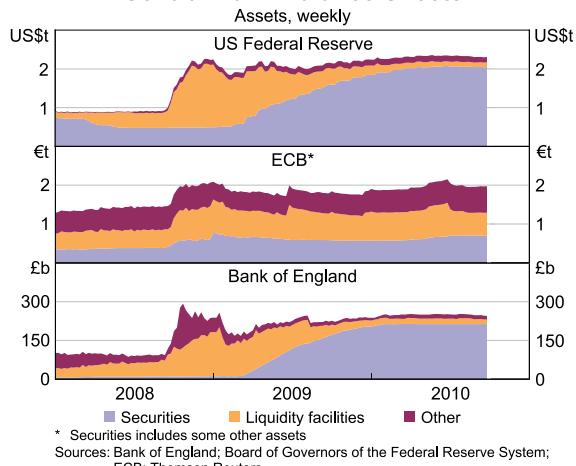
banks have signalled a commitment to stimulatory monetary policy for the period ahead and, in some countries, have purchased securities (Graph 10). The US Federal Reserve and the Bank of England have completed their announced securities purchase programs, though in August the Fed announced that it would re-invest principal repayments from its holdings of agency securities into longer-term Treasuries, and there has been speculation that the securities purchase program may be re-opened.

Conditions in international bank funding markets have remained unsettled over the past six months. Spreads on bank debt widened around April and May on sovereign debt fears (Graph 11). Banks' senior debt issuance slowed sharply during that period, but has subsequently increased (Graph 12).

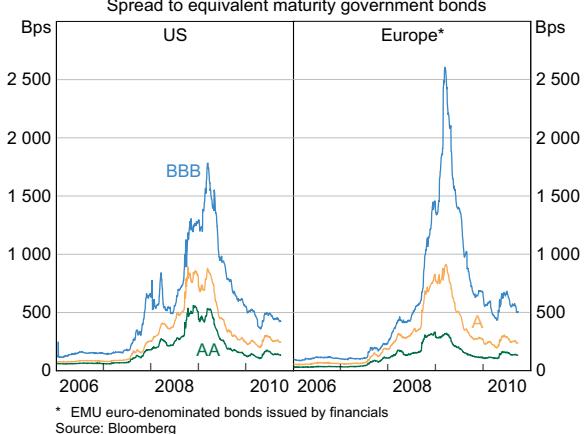
In addition to pressures from sovereign debt concerns, European bank funding has been a focus because of the relatively large amount of maturing bonds in the next few years, including bonds that had been issued under wholesale funding guarantee schemes. Reduced access to private markets has seen banks in Greece and some other peripheral euro area economies sharply increase their use of ECB funding, as discussed in 'Box A: Banking Systems in Greece, Portugal and Spain'. Several European countries, including Germany, Ireland and Spain also recently extended the expiry date for their wholesale funding guarantee schemes to end December 2010. European institutions have recently raised funding through the covered bond market, though issuance has slowed since the ECB's €60 billion covered bond purchase program ended in June.

Subdued private financing activity is evident across both intermediated and non-intermediated markets, reflecting ongoing caution among both lenders and borrowers. In the United States, euro area and United Kingdom, business credit has continued to fall over the six months to June, though the rate of contraction has eased in some countries (Graph 13). Housing credit growth is more varied across countries: there have been further declines in the United States, where the housing cycle has been

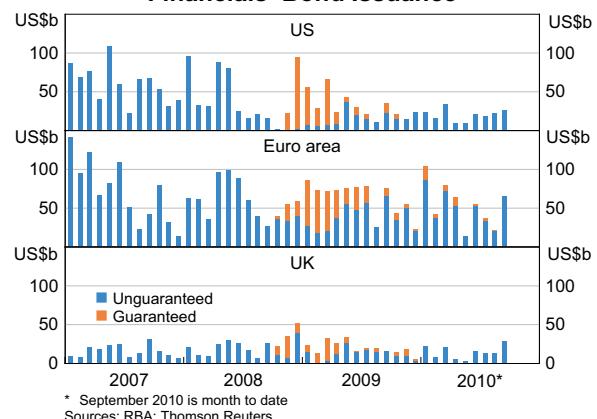
Graph 10
Central Bank Balance Sheets



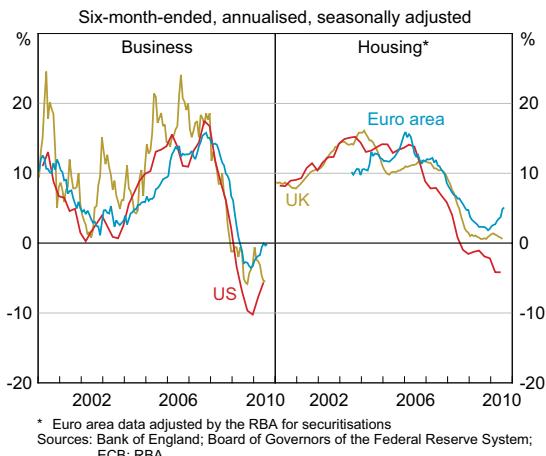
Graph 11
Banks' Bond Spreads



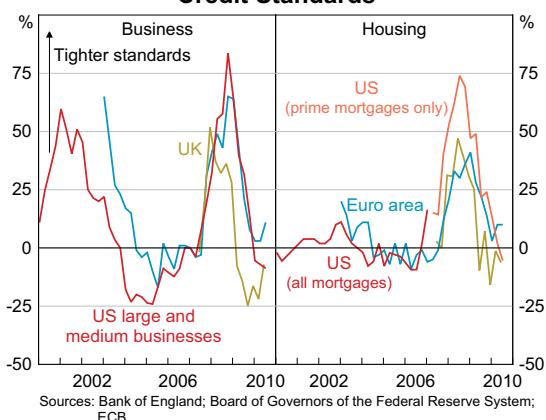
Graph 12
Financials' Bond Issuance



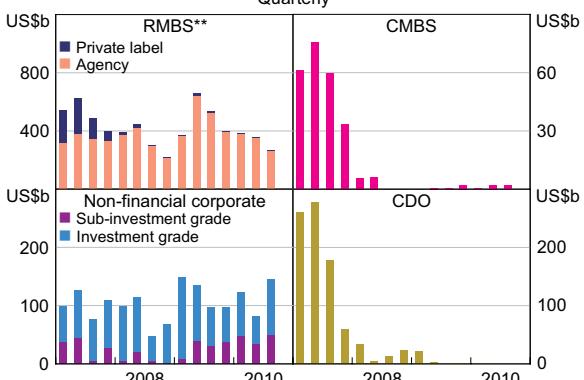
Graph 13
Credit Growth



Graph 14
Credit Standards



Graph 15
US Debt Issuance*
Quarterly



more pronounced, but growth has recently picked up in the euro area.

Survey evidence shows that banks' willingness to lend has increased since the extremes of the crisis, but remains subdued overall (Graph 14). In the United States and United Kingdom a small net percentage of lenders reported easing lending standards in the first half of 2010 for both housing and business loans, and in the euro area the reported net share of institutions tightening is well below levels of previous years. Nonetheless, lingering uncertainty about funding, economic and financial conditions, and the nature and implications of the future regulatory environment may be contributing to a cautious approach from lenders. Loan officer surveys also generally show that, despite some recent increase, demand from borrowers remains fairly weak, reflecting both a desire to reduce leverage, and reduced ability to borrow given the weakness in collateral values.

Capital market funding (an alternative to intermediated credit for some, typically larger, borrowers) also remains relatively subdued in a number of markets, particularly in those considered more risky. Structured finance markets largely remain moribund, with issuance activity in the United States predominantly restricted to residential mortgage-backed securities with government-sponsored agency involvement (Graph 15). Leveraged buy-out activity is also well down on pre-crisis levels: in the year to June 2010, global deals totalled under US\$100 billion, compared with over US\$1 000 billion in the year to June 2007. Issuance of conventional corporate bonds has been relatively stronger. There are some indications that corporates have been responding to the fall in long-term interest rates by refinancing debt for longer maturities.

Capital raisings through equity issuance have eased a little since 2009, when firms were actively deleveraging (Graph 16). Consistent with the more cautious tone in funding markets, additional raisings

by listed firms continue to dominate activity, in contrast to the period immediately preceding the crisis when initial public offerings (IPOs) accounted for around one half of all equity raisings. Equity raisings by financial firms have also eased after relatively strong activity in 2009.

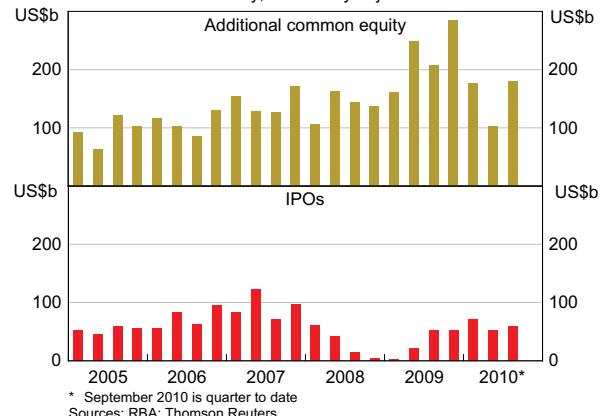
Loan Quality and Asset Prices

The decline in flows of provisions for bank loan losses in some countries (discussed in the section on Profitability and Capital) has, more recently, been reflected in falls in the stock of non-performing loans. In the United States, the share of non-performing loans across all FDIC-insured institutions fell in the June quarter, after having broadly stabilised in March (Graph 17). Historical data show that this is the usual pattern, with declining flows of provisions ultimately reflected in an improvement in the share of non-performing loans, as fewer loans become impaired, and existing impaired loans either revert to performing status or are written off.

Disaggregated data show that the improvement in loan quality in the United States has been fairly broad based across loan categories: there has been a mild dip in non-performing loan ratios across consumer, commercial, and both commercial and residential real estate categories (Graph 18). Though comparable data across these categories are generally not available for other banking systems, available housing loan data suggests some broader signs of steady in countries such as Spain and the United Kingdom (Graph 19). As in earlier episodes, stimulatory monetary and fiscal policy settings and the associated recovery in economic conditions have played a role in the improvement. Lower interest rates have eased debt servicing burdens, and unemployment has stabilised or fallen in a number of countries. Given the relatively greater magnitude of the stimulus in the current episode, however, questions remain about the resilience of the recovery to its removal.

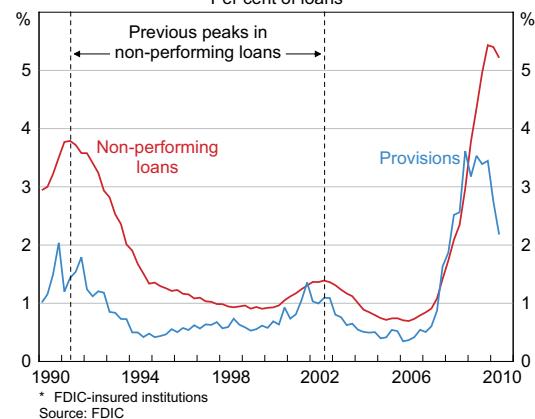
Graph 16
Global Gross Equity Issuance

Quarterly, seasonally adjusted



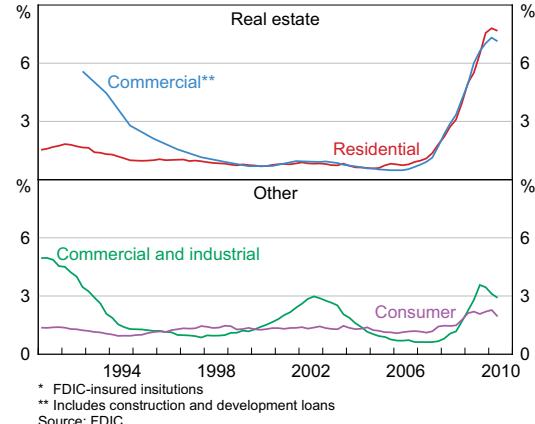
Graph 17
US Loan Quality Indicators*

Per cent of loans

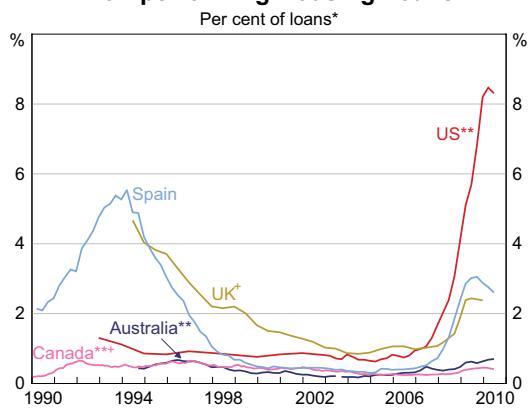


Graph 18
US Non-performing Loans*

Per cent of loans



Graph 19 Non-performing Housing Loans



* Per cent of loans by value; includes 'impaired' loans unless otherwise stated;
for Australia, only includes loans 90+ days in arrears prior to September 2003

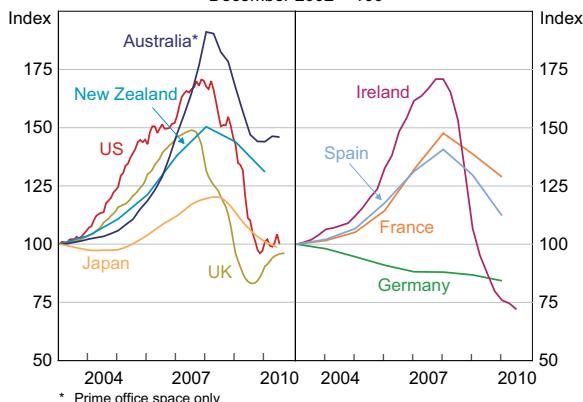
** Banks only

+ Per cent of loans by number that are 90+ days in arrears

Sources: APRA; Bank of Spain; Canadian Bankers' Association; Council of Mortgage Lenders; FDIC; RBA

Graph 20 Commercial Property Prices

December 2002 = 100

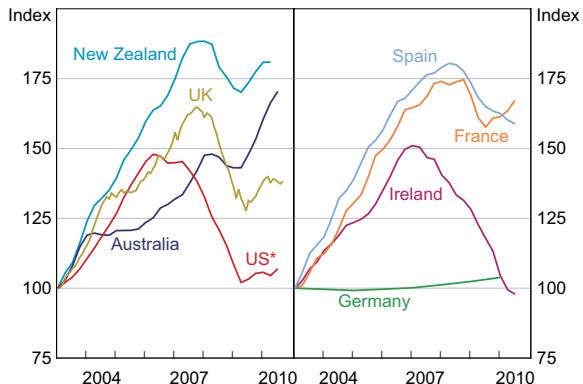


* Prime office space only

Sources: Bloomberg; Jones Lang LaSalle; RBA

Graph 21 Dwelling Prices

December 2002 = 100



* Prices of detached houses only

Sources: APM; Bloomberg; RBA; Thomson Reuters

Property-related exposures remain a key focus for the loan quality of many banking systems. In the United States, real estate loans typically account for the majority of banks' loans, and the share of non-performing loans for property – particularly residential real estate – remains above previous peaks. In the euro area and the United Kingdom, available data suggest that commercial property also continues to figure prominently in non-performing loans.

Collateral values continue to be a problem for many commercial property exposures, as prices remain well below their peaks in many countries (Graph 20). In the United States and the United Kingdom, commercial property prices in June were 4 per cent and 15 per cent above their respective troughs, but remain around 40 per cent and 35 per cent respectively below the peaks in 2007. Commercial real estate price data for 2010 are not widely available across the major euro area countries, but prices in Ireland recorded another decline, to be 58 per cent below the recent peak. The falls in property prices raise concerns that borrowers will be unable to refinance maturing loans: in the United States about 40 per cent of financial institutions' commercial real estate loans are expected to mature in the period 2010–2014, of which around one half is estimated to have a loan value exceeding the current collateral value.

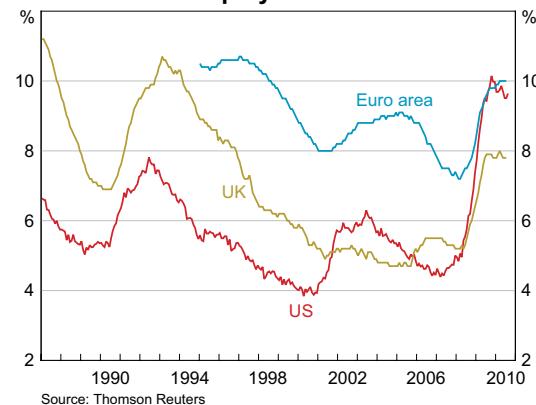
Residential property prices also remain well below their peaks in many countries (Graph 21). Again, this is despite some recent mild price gains in some markets; for example in mid 2010 residential property prices in the United States and United Kingdom were 5 per cent and 9 per cent, respectively, above their recent lows. In the case of the United States, housing market activity appears to have been temporarily boosted by the Government's home-buyer tax credit, which expired in April 2010, but activity has since fallen. Housing markets in many euro area countries are yet to show significant signs of improvement.

Relatively subdued conditions in asset markets are likely to persist while private financing activity

remains weak, and elevated levels of unemployment remain a drag on both confidence and capacity to service debt. While the US unemployment rate has fallen slightly over recent months, it remains more than double the level before the onset of the financial crisis (Graph 22). In the euro area and United Kingdom, unemployment rates are little changed from their recent peaks of 10 per cent and 8 per cent respectively. There is considerable variation across the euro area: in Germany, the unemployment rate has declined by 0.7 percentage points over the year to 7 per cent in July whereas in Spain, the unemployment rate has increased further and remains over 20 per cent.

Loan quality considerations are quite different for many emerging market economies, including in Asia, where actual and expected growth outcomes are much stronger than developed economies (Table 3). Given growth and, increasingly, interest rate differentials to developed economies, concerns are more focused on capital inflows to countries with managed exchange rate regimes and less well-developed financial systems, and the potential for unsustainable asset price rises to undermine future asset quality. The turnaround in net capital flows to Asia between 2008 and 2009 was particularly strong, although net flows have eased a little in the most recent observation (Graph 23).

Graph 22
Unemployment Rates



Graph 23
Net Private Capital Flows to Asian Economies
Per cent of GDP, quarterly

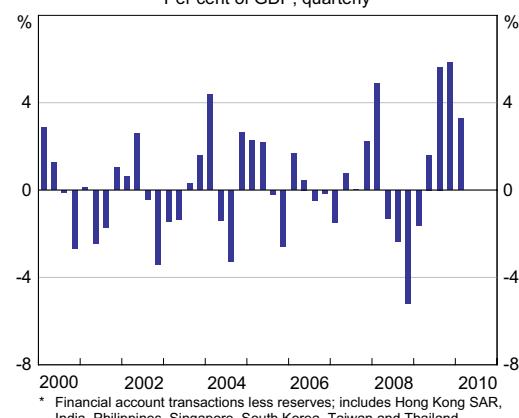


Table 3: World GDP Growth
Year average, per cent^(a)

	2008	2009	2010	2011 IMF forecasts ^(b)
United States	0.0	-2.6	3.3	2.9
Euro area	0.5	-4.1	1.0	1.3
Japan	-1.2	-5.2	2.4	1.8
China	9.6	9.1	10.5	9.6
Other east Asia ^(c)	2.8	0.0	6.5	5.0
India	6.4	5.7	9.4	8.4
World	3.0	-0.6	4.6	4.3
Australia	2.2	1.2	3.0	3.5

(a) Aggregates weighted by GDP at PPP exchange rates unless otherwise specified

(b) Forecasts from the July *World Economic Outlook Update*

(c) Weighted using GDP at market exchange rates

Sources: CEIC; IMF; RBA; Thomson Reuters

Consistent with the turnaround in capital inflows and relatively stronger outlook for economic growth, asset prices have increased substantially in some emerging markets. For example, share price indices in emerging Asia and Latin America have significantly outperformed those in the developed world since the end of 2008, with broad indices showing gains of around 60 per cent to 75 per cent compared with around 25 per cent in developed countries. In Asia, residential property prices in China, Hong Kong SAR, Singapore and Taiwan have experienced strong growth since late 2008 and early 2009, partly reflecting strong growth in economic activity and incomes (Graph 24).

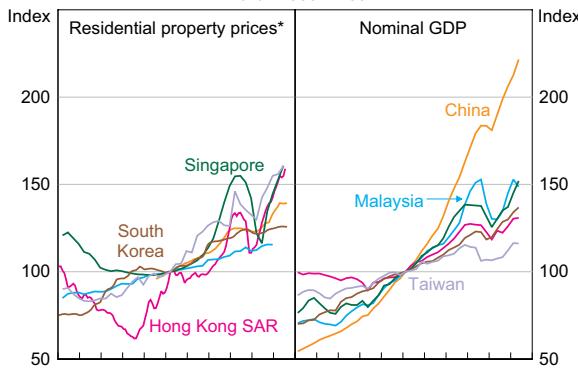
Authorities in some Asian countries are using various policy measures to address rising property prices. In China, the Government has introduced various measures including increasing minimum down-payments and mortgage rates for those purchasing their second (or more) property, discouraging bank lending to third-home buyers, auditing land holdings by property developers to ensure land and housing is not being hoarded, and reducing some state-owned companies' involvement in property markets. The Hong Kong authorities recently took measures that include reducing maximum loan-to-valuation ratios for luxury and investment properties, tightening

restrictions on debt-servicing ratios, increasing land supply and increasing the cost of speculative transactions. In Singapore, the Government imposed sellers' stamp duty on property resales within a specified period, raised the minimum down-payment required for home financing and increased the supply of public housing.

In a number of countries central banks have tightened monetary policy, and other actions have been implemented to restrict new lending. The Chinese authorities have strengthened the supervision of lending to local government investment vehicles, and have prohibited local governments from guaranteeing their debts. The China Banking Regulatory Commission has ordered banks to report on their exposures to local government investment vehicles by the end of the year. Local governments set up these vehicles to fund mainly infrastructure and property development projects and their borrowing had increased rapidly during the financial crisis, supported by central government funds. On capital flows, Indonesia has introduced measures designed to shift capital inflows away from short-term central bank debt into longer-term investments, while South Korea imposed stricter currency controls to stabilise flows and reduce currency volatility.

Graph 24
Asset Prices and Nominal GDP

March 2005 = 100



* For China, data are an average of new and existing residential property prices
Sources: CEIC; RBA