

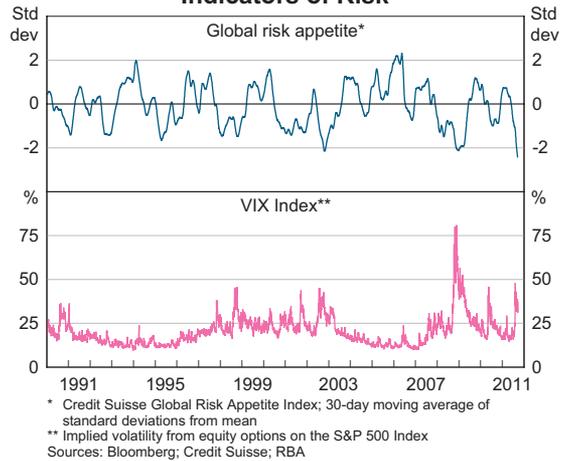
1. The Global Financial Environment

Public finances have deteriorated substantially in a number of advanced economies since the onset of the financial crisis, particularly in Europe, leading to growing market concerns about the sustainability of sovereign debt. Difficulties were initially centred on Greece, Ireland and Portugal, which all received international bailout packages during the past year and a half. But more recently, sovereign debt concerns have spread to a wider range of countries in Europe, including the much larger economies of Italy and Spain. Severe market reactions to sovereign credit risk have resulted in funding difficulties for banks in some of these countries and tensions in broader euro area bank funding markets. Although they are not as pressing as the problems in Europe, there have also been concerns about unsustainable public debt dynamics in the United States and Japan.

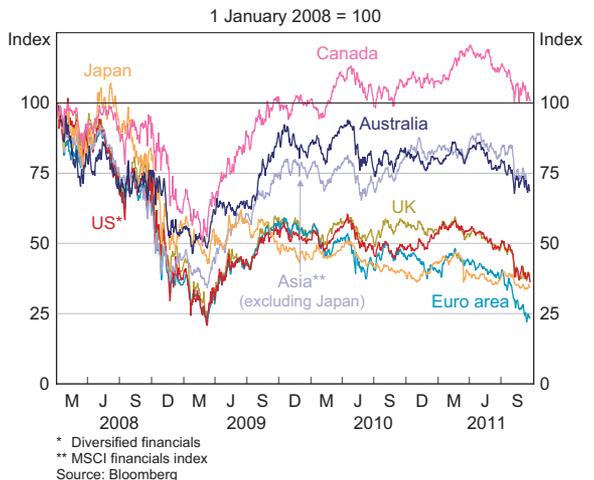
Risk aversion and volatility in global financial markets have increased sharply since the start of August (Graph 1.1). This was triggered by a combination of factors, including: growing concerns about the creditworthiness of some large sovereigns in Europe; concerns about the passage of the US debt-ceiling increase, followed by Standard & Poor's (S&P) downgrade of the US credit rating; a weaker economic outlook in the United States and Europe; and related fears about the effect on financial systems. Underlying all this, markets seem to have become increasingly pessimistic about the ability of policymakers to resolve the situation, given the apparent lack of political support within and across some countries, and the limited policy tools available. Across many countries, prices of shares and other risk assets have declined sharply since early

August. Bank and insurer share prices have been particularly affected, falling by more than 15 per cent in most countries, to be around their lowest levels since early 2009 (Graph 1.2). Credit markets have

Graph 1.1
Indicators of Risk



Graph 1.2
Banks' Share Prices



also tightened globally, although conditions are still generally better than they were during the height of the crisis in 2008–09.

This current episode of risk aversion and volatility follows a number of periods of heightened market turbulence over the past couple of years. These periodic events indicate that financial market participants remain sensitive to bad news following the experience of 2008–09. While the latest bout of market uncertainty is not on the scale of 2008–09, it is unclear at this stage whether it will be another temporary episode or whether it is foreshadowing a more serious market dislocation.

Compared to the pre-crisis period, the large banks in the major advanced economies are better placed to withstand a period of renewed market stress. In particular, they have significantly strengthened their capital positions over the past few years and there is now less uncertainty about banks' exposures than there was during the crisis. Funding structures have also generally been improved, although some banks are still relatively reliant on short-term wholesale funding and are therefore susceptible to market strains. Most large banks have continued to post solid profits over recent periods. Even so, a further escalation in sovereign strains within Europe could adversely affect some large banks by increasing their funding costs and causing asset write-downs. Many of these banks are also vulnerable to a slowing in the pace of economic recovery because they still have an elevated level of non-performing loans, particularly property-related loans, and property markets are still weak in many advanced economies.

Banking systems in emerging Asia remain in much better shape than those in the major advanced economies. The profitability of large banks in the Asian region has been strong recently, supported by robust growth in deposits and lending. These banks are relatively well placed to cope with the current market strains: they are largely focused on strongly growing domestic markets and have little direct exposure to euro area sovereigns and banks. However, asset prices and credit have been growing strongly in a few Asian countries, so any unwinding

in asset markets there could expose credit quality problems.

Global reinsurers and general insurers have been dealing with a number of large catastrophe events in 2011. While these firms have experienced significantly lower profits as a result, they have maintained high capital buffers.

Sovereign Debt Concerns

Market concerns about the sustainability of some countries' sovereign debt positions in Europe intensified over the past six months. Portugal came under significant funding pressure during March and April, forcing it to request international financial assistance from the European Union (EU) and International Monetary Fund (IMF). A rescue package was announced in early May, making Portugal the third euro area country to receive a bailout after Greece and Ireland in 2010.

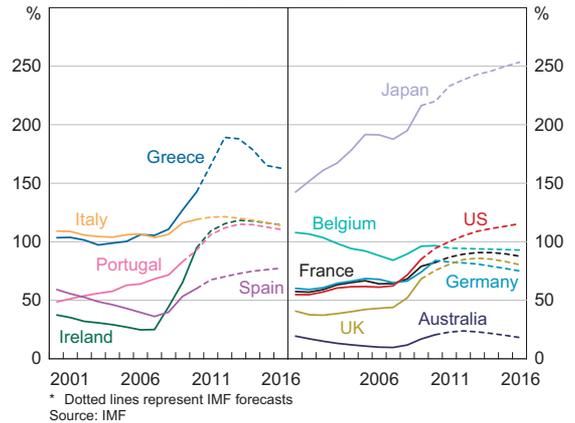
Greece also came under renewed market pressure during the past six months because of difficulties in meeting the terms of its 2010 bailout package. Concerns that it would be unable to re-enter debt markets in 2012 as previously assumed raised the prospect of a further funding shortfall. Protracted negotiations over another assistance package and demands for private-sector burden-sharing caused significant uncertainty in markets around the middle of the year. A second EU/IMF rescue package for Greece was eventually announced in July. It aims to improve Greece's long-term debt position by extending the maturities and reducing the interest rates on its new EU loans (these more generous loan terms will also be applied to Ireland and Portugal), and by providing funding to buy back debt from private investors. The revised program also envisages that part of the funding shortfall will be met from private investors rolling over debt and exchanging existing bonds for new bonds with longer maturities, with these measures expected to result in private investor losses on Greek sovereign debt of about 20 per cent on average. In addition, Greece agreed to implement tougher fiscal tightening measures and sell some state assets. Even with these measures,

the IMF is forecasting Greece's public debt-to-GDP ratio to continue to rise sharply in 2012 due to further fiscal deficits and weak economic conditions (Graph 1.3).

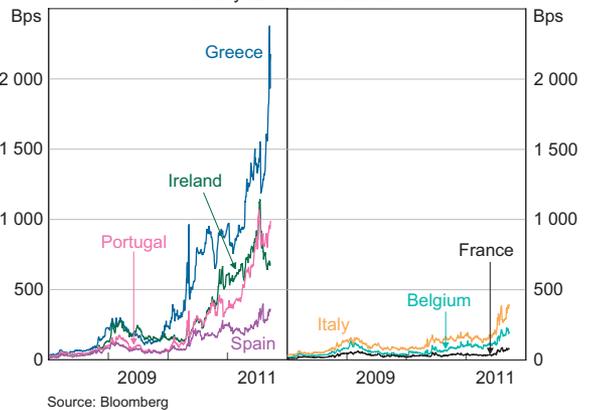
While the second assistance package for Greece is yet to be fully approved, deteriorating economic conditions mean the country has been struggling to meet the terms of its original bailout package. This has contributed to uncertainty about whether further tranches of financial assistance under the first package will be provided by the EU and IMF, which has been weighing on market sentiment in recent weeks. Associated with this, there has been increasing market speculation that Greece may default, and spreads on Greek government debt have risen sharply as a result (Graph 1.4). By contrast, market sentiment towards Ireland has improved over recent months, with 10-year Irish government bond yields declining by about 5½ percentage points since mid July. Underlying this, market participants seem increasingly confident that Ireland will meet the fiscal and banking reform targets set out in its international assistance package.

More generally, to help support financial stability in the region, EU authorities have in recent months announced plans to expand the role of the European Financial Stability Facility (EFSF), and its replacement from mid 2013, the European Stability Mechanism (ESM), including by allowing them to purchase sovereign debt on secondary markets and finance bank recapitalisations. The effective lending capacity of the EFSF was also increased to €440 billion (about €50 billion is already allocated), or €500 billion in the case of the ESM. However, some market commentators continue to doubt whether these facilities would be sufficient to resolve funding difficulties for some large euro area sovereigns with high debt if they were to get into trouble. Indeed, concerns about sovereign debt sustainability in Italy and Spain escalated in July. Government bond yields in these countries rose briefly to their highest levels since at least the introduction of the euro in 1999. S&P downgraded Italy's credit rating from A+ to A

Graph 1.3
General Government Gross Debt*
Per cent of GDP



Graph 1.4
European Government Bond Spreads
To 10-year German Bunds



(with a negative outlook) in mid September, in part due to weaker economic growth prospects.

With the changes to the EFSF yet to be approved by national parliaments, the European Central Bank (ECB) resumed purchases of euro area government debt in secondary markets in August under its Securities Markets Program. Around €150 billion of sovereign debt has been purchased since the inception of this program, with recent purchases of about €80 billion believed to comprise mostly Italian and Spanish sovereign bonds. The yields on these countries' long-term bonds initially fell noticeably, but have subsequently risen again in association with

fears over softening regional economic conditions and delays in the establishment of the second Greek rescue package.

Although not as pressing as the situation in the euro area, there have also been concerns about government debt sustainability in the United States and Japan. Government debt-to-GDP ratios are high in both of these countries, especially so in the case of Japan, and are projected by the IMF to continue to rise over the next four years at least (Graph 1.3). S&P downgraded the US credit rating from AAA to AA+ (with a negative outlook) in August based on its view that the US political system may be unable to reach agreement on the fiscal consolidation measures required to restore the United States to a sustainable fiscal path. S&P subsequently downgraded the credit ratings of a number of US agencies, banks and clearinghouses whose status is dependent on that of the sovereign. This contributed to the increased market turbulence in August. Japan's sovereign credit rating was also downgraded in August; Moody's reduced the rating one notch to the equivalent of AA-, bringing it into line with S&P's rating, which had been downgraded earlier in the year. Despite rating changes, long-term government bond yields in the United States and Japan have fallen since the start of August as risk aversion has grown.

The severe market reactions to the deteriorating sovereign debt positions have left governments with a difficult balancing act: credible fiscal consolidation plans are required to allay concerns about debt sustainability, yet tightening budget positions too much and too early may undermine economic recovery and thus fiscal positions. A further complication is that there is less scope for monetary policy in the affected countries to counterbalance any fiscal consolidation. The governments of a number of European countries have recently introduced some further short- and medium-term fiscal consolidation measures, but market participants are pressuring some of them to strengthen these plans.

The Impact of Sovereign Credit Risk on Bank Funding

An increase in sovereign credit risk can adversely affect banks' balance sheets and funding in several ways. It can induce losses on banks' direct holdings of government debt; reduce the value of the collateral banks use to raise funding; and reduce the funding benefit banks receive from implicit and explicit government support.¹ Accordingly, sovereign credit rating downgrades often lead to downgrades of those countries' domestic banks. Moreover, sovereign risk in one country can spill over to banks in other countries through a number of channels, including through banks' holdings of foreign sovereign debt, cross-border exposures to other banks and claims on non-financial entities in affected foreign countries. These kinds of inter-linkages have been particularly important within the euro area in recent months.

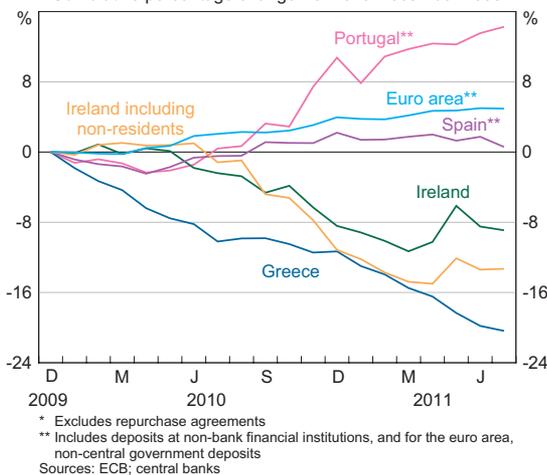
Concerns about sovereign risk in Greece, Ireland and Portugal have been contributing to difficult funding conditions for banks in these countries for some time, compounding the problems they were already facing from weak domestic economic conditions and property prices. As these countries' sovereign credit ratings have been progressively downgraded, many of their banks have also had their ratings downgraded (generally to below investment grade). Funding spreads for these banks have widened sharply, making it difficult for them to raise wholesale debt, and forcing them to rely more on central bank funding or other forms of official support. As at end July, central bank lending was equivalent to about 20 to 25 per cent of Greek and Irish banks' assets and around 8 per cent of Portuguese banks' assets.

Despite stronger competition for deposits, banks in some of these countries have also experienced substantial deposit outflows. Greek banks' domestic private sector deposits have declined by about one-fifth since the end of 2009, with reports that

¹ Committee on the Global Financial System (2011), 'The Impact of Sovereign Credit Risk on Bank Funding Conditions', CGFS Papers, No 43, July.

depositors have been shifting money to other countries on concerns about possible devaluation in the event that Greece abandons the euro (Graph 1.5). Irish banks have also experienced significant deposit outflows, especially of non-residents' deposits, which have declined by more than 25 per cent since mid 2010, compared with a 7 per cent fall in residents' deposits. By contrast, deposits in Portuguese and Spanish banks have generally held up over the past year.

Graph 1.5
Banks' Domestic Private Sector Deposits*
 Cumulative percentage change from end December 2009



Italian banks, which have significant exposures to the Italian sovereign, have also come under greater funding pressure in recent months as sovereign debt concerns have spread to Italy. Their borrowing from the ECB has increased substantially since June, from €40 billion to €85 billion, equivalent to about 2 per cent of their assets. Spanish banks have also increased their borrowing from the ECB over the past couple of months. Compared with Greece, Ireland and Portugal, increases in sovereign risk in Italy and Spain have the potential for much larger regional repercussions given the greater amount of their debt on issue and its wider distribution within the euro area. Excluding domestic banks, net

exposures of European banks to Italian sovereign debt are equivalent to around 13 per cent of these banks' aggregate core Tier 1 capital, compared with 4 per cent for Spanish sovereign debt, and 6 per cent for Greek, Irish and Portuguese sovereign debt combined (Graph 1.6).

As sovereign risk has spread to a broader range of countries, investors have become increasingly concerned about the exposures of some of the larger European banking systems to banks and sovereigns of the affected countries (Table 1.1). Many large European banks are also exposed through their direct lending to households and businesses in these countries, the performance of which would be expected to deteriorate if sovereign or banking strains exacerbated the weakness in local economic conditions. Reflecting these significant cross-border exposures, CDS premia for banks in France and Germany have recently widened and their share prices have fallen sharply (Graph 1.7). Moody's downgraded the credit rating of a large French bank in mid September because of its significant exposure to Greece.

Graph 1.6
EU Banks' Sovereign Exposures*

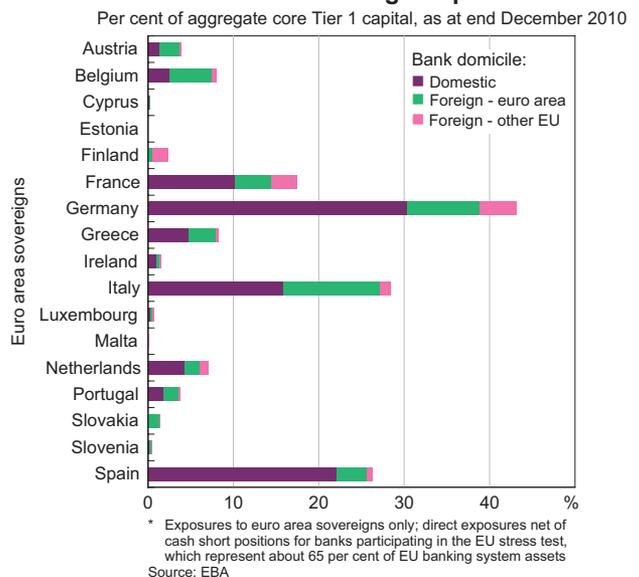


Table 1.1: Foreign Bank Claims on Euro Area Countries^(a)
 Ultimate risk basis, as at 31 March 2011, per cent of lending country's total bank assets^(b)

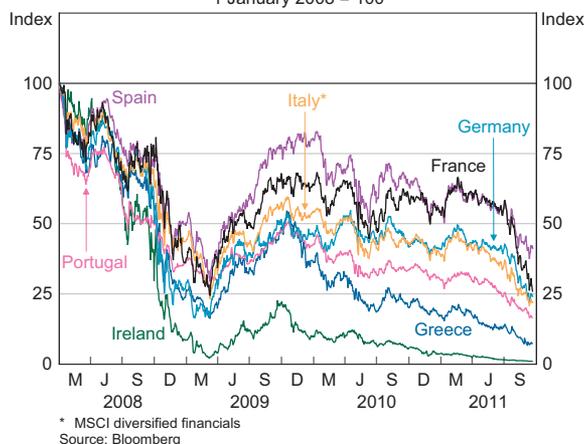
| Reporting banks (by headquarter location) | Greece | Ireland | Italy | Portugal | Spain | Subtotal | Total euro area |
|---|--------|---------|-------|----------|-------|----------|--------------------|
| Euro area banks | 0.2 | 0.5 | 1.6 | 0.4 | 1.1 | 3.9 | 10.5 |
| <i>of which:</i> | | | | | | | |
| <i>Belgian</i> | 0.1 | 1.7 | 1.6 | 0.2 | 1.4 | 5.1 | 12.9 |
| <i>Dutch</i> | 0.2 | 0.6 | 1.5 | 0.2 | 2.4 | 4.9 | 18.2 |
| <i>French</i> | 0.5 | 0.3 | 3.8 | 0.3 | 1.3 | 6.2 | 13.2 |
| <i>German</i> | 0.2 | 1.0 | 1.5 | 0.3 | 1.6 | 4.6 | 10.9 |
| <i>Italian</i> | 0.1 | 0.3 | – | 0.1 | 0.6 | 1.0 | 10.6 |
| <i>Portuguese</i> | 1.3 | 0.7 | 0.4 | – | 3.5 | 5.9 | 9.5 |
| <i>Spanish</i> | 0.0 | 0.2 | 0.7 | 1.8 | – | 2.8 | 5.4 |
| Swiss banks | 0.1 | 0.5 | 0.7 | 0.1 | 0.8 | 2.2 | 12.6 |
| UK banks | 0.1 | 1.2 | 0.6 | 0.2 | 0.9 | 3.1 | 9.3 |
| US banks | 0.1 | 0.3 | 0.3 | 0.0 | 0.3 | 1.0 | 5.1 |
| Japanese banks | 0.0 | 0.2 | 0.4 | 0.0 | 0.2 | 0.9 | 4.4 |
| Australian banks | – | 0.2 | 0.1 | – | 0.1 | 0.3 | 1.8 |

(a) Based on 24 countries reporting to the BIS

(b) Monetary financial institutions' assets 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 1.7
Euro Area Banks' Share Prices
 1 January 2008 = 100

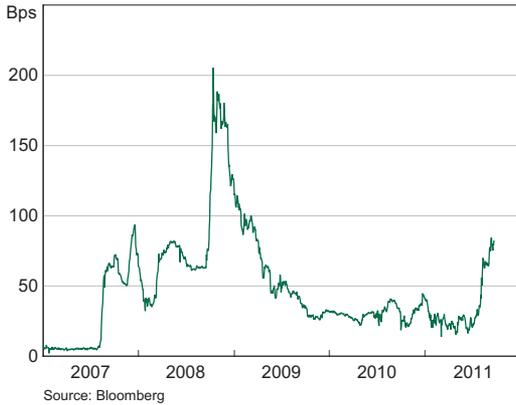


* MSCI diversified financials
 Source: Bloomberg

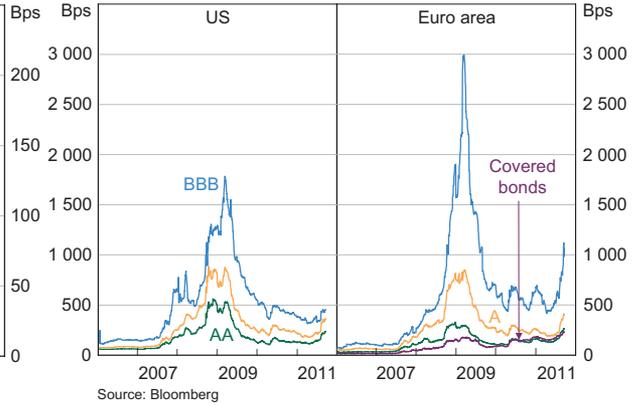
Concerns about banks' exposures within the euro area have contributed to a tightening of credit markets in recent months, although conditions remain better than in 2008–09. In money markets, the spread between 3-month interbank lending

rates (Euribor) and expected overnight rates has risen by more than 45 basis points since the start of August, to the highest level since early 2009 (Graph 1.8). US dollar funding pressures have also emerged as access to US commercial paper and deposit markets have been curtailed. US money market funds, which are significant providers of short-term US dollar funding to European banks, have experienced sizeable investor outflows in recent months. While these money market funds had already all but stopped their lending to banks in Greece, Ireland, Italy, Portugal and Spain, they have recently also been reducing and shortening their exposures to banks in other euro area countries. In response, the ECB and four other major central banks recently announced co-ordinated 3-month US dollar liquidity operations on specific dates later this year. These operations are in addition to the seven-day US dollar liquidity facilities already offered by the ECB and the Bank of England.

Graph 1.8
3-month Euribor Spread
To overnight indexed swaps



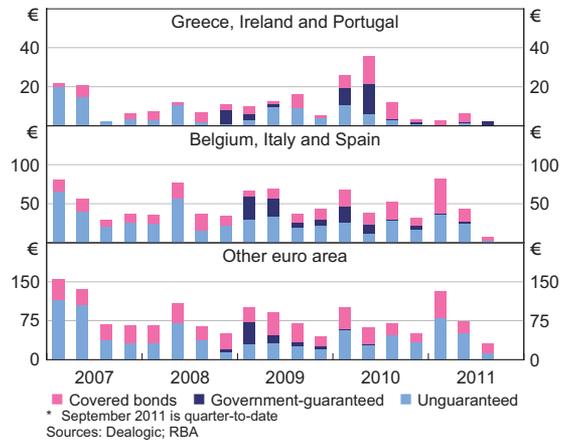
Graph 1.9
Banks' Bond Spreads
To equivalent maturity government bonds



Spreads on longer-term bank debt in the euro area have now increased to above the levels seen in mid 2010, although for higher-rated unsecured bonds and covered bonds these increases are entirely due to lower benchmark sovereign yields (Graph 1.9). Consistent with this shift in credit market conditions, bond issuance by euro area banks has slowed in recent months (Graph 1.10). However, issuance (other than by Greek, Irish and Portuguese banks) had been strong earlier this year, suggesting that some banks may not need to access term debt markets in the near future. The larger European banks have also bolstered their liquidity positions since the crisis. Even so, many of them are still relatively reliant on wholesale funding, including short-term US dollar funding. There is a risk, therefore, that if the sovereign debt problems in Europe were to deepen or become more protracted, these larger European banks could encounter more severe funding strains, which could then propagate stresses more broadly in the global financial system.

While heightened risk aversion associated with the sovereign debt problems in Europe has resulted in a sharp increase in global market volatility over the past couple of months, bank funding markets outside the euro area have so far been less affected. Short-term interbank spreads have increased by much less in the United States and United Kingdom this year than in the euro area. Bank bond spreads

Graph 1.10
Euro Area Banks' Bond Issuance*



have widened across a number of markets, although the increases for lower-rated issuers have been less than in the euro area. Large banks in the United States and United Kingdom have significantly increased the share of their funding from deposits over the past few years, which should make them more resilient to stresses in wholesale funding markets.

Bank Capital

Bank capital positions have been strengthened substantially since the 2008 crisis, increasing the resilience of the major banking systems, and in principle helping them to cope with a renewed period of market stress. Progress in improving bank

capital positions has tended to be slower in the euro area than in other regions over the past few years, although recently there has been a more concerted effort to raise additional capital.

Bank supervisors in a number of the troubled euro area countries have recently raised the minimum core Tier 1 capital requirements for their banks, to levels above the future Basel III requirements, and with a shorter timetable for adherence (Table 1.2). This has forced some banks in these countries to raise capital, either privately or from the government, including from funds set aside in international financial assistance programs. The aim of these measures is to shore up market confidence in banks' solvency given the weak domestic economies and their sizeable exposures to domestic sovereign debt.

More generally, the recently completed EU-wide bank stress test has provided some impetus for improving bank capitalisation in the region. The results of the stress test, published by the European Banking Authority (EBA) in July, included detailed information on the capital positions of 90 EU banks (representing about 65 per cent of EU banking system assets). Capital raisings and other measures affecting bank capital positions (such as mandatory restructuring plans) were required to be publicly announced and committed to by end April if they were to be included in capital for the purposes of the test. In aggregate, participating banks undertook

€50 billion in approved capital measures in the first four months of 2011, adding 0.4 percentage points to their aggregate end 2010 core Tier 1 capital ratio of 8.9 per cent.

The EU stress test found that the majority of participating banks maintained reasonable capital buffers under a two-year stress scenario for the macroeconomy and financial markets. Eight relatively small banks failed to meet the benchmark 5 per cent core Tier 1 capital ratio under the stress scenario (see 'Box A: European Bank Stress Tests'). Nearly all of these banks were from countries where bank supervisors have already raised the minimum core Tier 1 capital requirement.

Detailed information on participating banks' sovereign and other exposures to individual EU countries were disclosed in conjunction with the EU stress test results. This enhanced transparency should mean there is less uncertainty about EU banks' problem exposures than there was during the 2008 crisis, along with the fact that these exposures are less complex than the structured securities that triggered the crisis. While this transparency should help limit any contagion effects, market participants seem increasingly concerned about the creditworthiness of some EU banks' exposures to euro area countries where the economic outlook has deteriorated noticeably since the EU stress test was conducted. This, in turn, has raised questions

Table 1.2: Core Tier 1 Capital Ratios for Banks in Selected Euro Area Countries

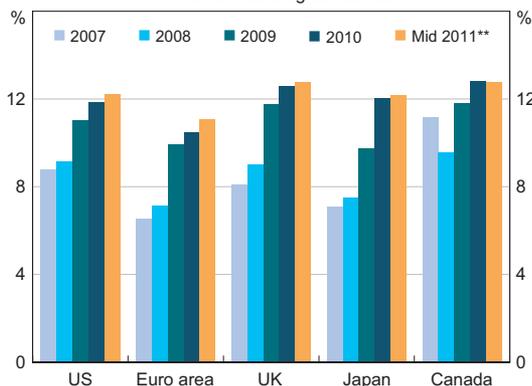
| | Minimum requirement Per cent of risk-weighted assets | Supervisory deadline |
|---|---|-----------------------|
| Cyprus | 8 | July 2011 |
| Greece | 10 | January 2012 |
| Ireland | 10½ | March 2011 |
| Portugal | 9 and 10 | End 2011 and end 2012 |
| Spain | 8 or 10 ^(a) | September 2011 |
| <i>Memo items:</i> | | |
| Basel III common equity Tier 1 | 3½ and 4½ | January 2013 and 2015 |
| Basel III common equity Tier 1 plus conservation buffer | 7 | January 2019 |

(a) Minimum requirement is 10 per cent for those banks which are not listed or are more reliant on wholesale funding
Sources: BCBS; national authorities

about the adequacy of these banks' capital and funding positions.

Outside the euro area, bank capital positions have been strengthened further in most other major banking systems during the past year. Recent increases in Tier 1 capital ratios for banks in the United States, United Kingdom, Japan and Canada have generally been smaller than in the euro area, but this mainly reflects that these banks bolstered their capital positions to higher levels in 2009 and 2010 (Graph 1.11). Unlike in the euro area, most of these banks have recently been accumulating capital largely through retaining earnings rather than raising new equity. Internal capital generation for the large US and UK banks has been aided by dividend payout ratios that are still below pre-crisis levels. Capital ratios have also been supported by slow growth in risk-weighted assets, in line with subdued credit growth.

Graph 1.11
Large Banks' Tier 1 Capital*
Per cent of risk-weighted assets

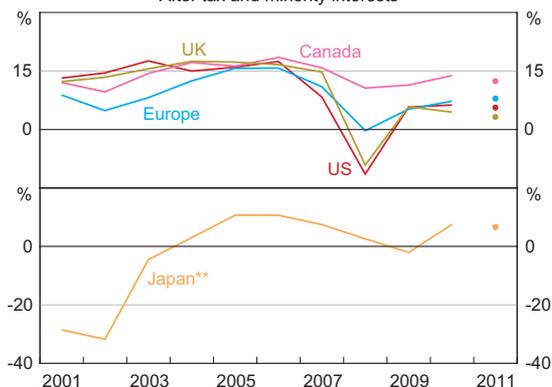


* Tier 1 capital ratios across banking systems are subject to definitional differences; includes the weighted average of: 19 large US banks, 52 large institutions from across the euro area, the five largest UK banks, the three largest Japanese banks and the six largest Canadian banks
** End June for US, euro area, UK and Japan; end July for Canada
Sources: Bloomberg; CEBS; EBA; FDIC; RBA; banks' annual and interim reports

Bank Profitability

The large banks in the major advanced countries generally continued to report profits in the first half of 2011, although results were quite mixed across institutions, and overall profit levels and returns on equity remained subdued compared to the pre-crisis period (Graph 1.12). Whereas declining

Graph 1.12
Large Banks' Return on Equity*
After tax and minority interests

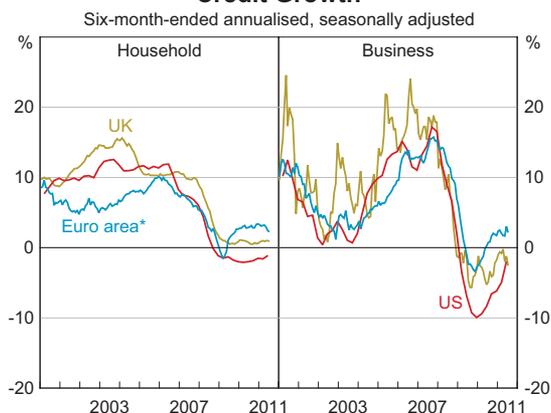


* Return on equity of the six largest US banks, 10 largest listed European banks (including Switzerland), five largest UK banks, four largest Japanese banks and six largest Canadian banks; 2011 profit is annualised and total equity is assumed constant from last reporting date
** 2001-07 results are to fiscal year ended 31 March
Sources: Bloomberg; RBA; banks' annual and interim reports

loan-loss provisions had supported banks' profit growth in 2010, provisions have fallen more modestly or been stable in recent periods. Trading income has tended to be volatile, reflecting shifts in market conditions, but was generally weaker for most large banks in the first half of 2011 than a year earlier. With net interest margins broadly steady, weak credit growth across the major banking systems has meant that growth in net interest income remains subdued.

Ongoing weak credit growth has been associated with continued weakness in property markets and hesitant economic growth in the major economies. The level of household credit (which mainly comprises housing credit) is still falling in the United States, and while household credit growth has recovered over the past year or so in the euro area, recent outcomes have been softer (Graph 1.13). Business credit has been even weaker and is still falling in the United Kingdom and the United States, although the rate of contraction is less than in 2009 and early 2010. Loan officer surveys generally indicate that demand for credit remains subdued. This is particularly the case for households, consistent with weak housing market conditions, high debt burdens and high unemployment.

Graph 1.13
Credit Growth



* Euro area data not adjusted for securitisations prior to 2009
Sources: Bank of England; ECB; RBA; Thomson Reuters

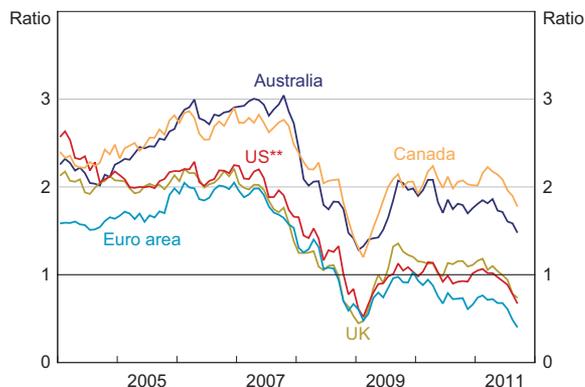
Aggregate profits of the six largest banking groups in the United States (representing around one-half of US banking system assets) were held down in the first half of 2011 by a large second-quarter loss at Bank of America. Bank of America's loss was mainly due to expenses related to buybacks of poorly underwritten mortgages and related legal costs. Profits of the remaining five large US banks were around 8 per cent higher than the year before, supported by further modest declines in loan-loss provisions. Some US banks are still facing the prospect of further large expenses related to the resolution of previous poor mortgage practices. Across all US Federal Deposit Insurance Corporation (FDIC) insured institutions, profits in the first half of 2011 were much higher than a year earlier, with results for smaller institutions improving noticeably.

In Europe, aggregate profits of the 10 largest banking groups (including two Swiss banks) were around 7 per cent lower over the year to the first half of 2011, in part reflecting difficult trading conditions for some banks related to the sovereign debt problems in Europe. Some large euro area and UK banks have also had to set aside significant provisions for expected losses on Greek sovereign debt held in their banking books. More recently, the Swiss bank UBS revealed estimated losses of around US\$2.3 billion incurred following unauthorised trading; these losses will

affect its profits for the second half of 2011. Profits of the large UK banks were mixed in the first half of 2011: those with significant exposures to emerging markets recorded growth in profits, while others continued to record losses, mainly due to substantial compensation payments to customers who were previously mis-sold loan payment protection insurance. For the large Japanese banks, profits in the first half of 2011 were about 4 per cent lower than a year earlier, although they were little affected by the earthquake and tsunami in March. The largest Canadian banks generally continued to post solid results in the latest half year, although one bank recorded a large fall in profits due to a loss on the sale of its US banking business.

The difficult macro-financial environment in the major economies continues to cloud the outlook for bank profitability. In the near term, the renewed market turmoil may result in some losses in banks' trading books and may adversely affect their investment banking revenues. Profits would be more severely affected if the sovereign debt problems in Europe were to escalate further, resulting in higher funding costs and more asset write-downs. Investors appear to be pessimistic about banks' future profitability, with the market valuation of many large banks in the euro area, the United Kingdom and the United States falling below the book valuation reported in their financial statements (Graph 1.14).

Graph 1.14
Banks' Price-to-book-value Ratios*

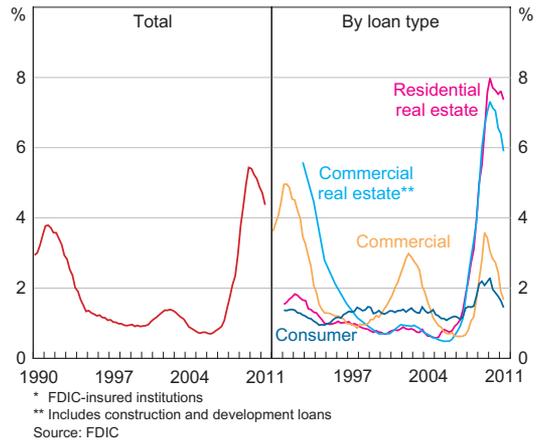


* Monthly; September 2011 observation is latest available
** Diversified financials
Source: Bloomberg

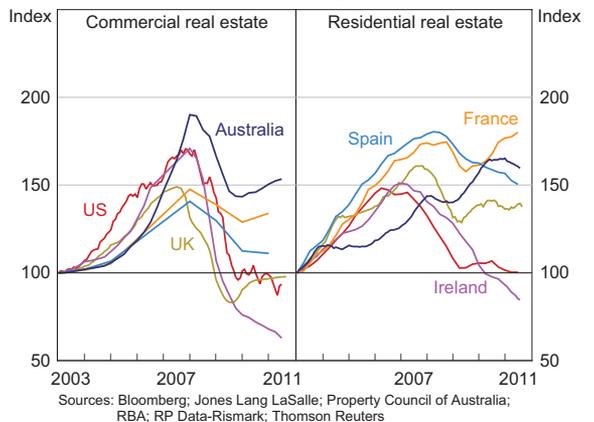
Property-related exposures remain another key vulnerability for banks in the major advanced countries. In the United States, non-performing loan ratios for both commercial and residential property remain around their historical highs, despite small declines since early 2010 (Graph 1.15). Troubled property exposures, particularly commercial real estate loans, continue to contribute to failures among smaller banks in the United States. Over the year to date, there have been 71 failures of FDIC-insured institutions in the United States; although this number represents only about 1 per cent of all US FDIC-insured institutions, more than 10 per cent of institutions are still considered vulnerable by the FDIC, a slightly larger proportion than the 1990 peak. In Europe, non-performing loans have continued to increase for many banks that have significant exposures to depressed property development markets. The available nationwide data indicate that bank non-performing loan ratios have increased further in Ireland and Spain over the past year.

Improved performance of these exposures would require a durable recovery in economic and property market conditions. Many commercial and residential property exposures are likely to be in negative equity, as property prices remain well below their peaks in most countries (Graph 1.16). Commercial and residential property prices continued to fall in the United States over the past year, as well as in a number of European countries, including Ireland and Spain – two countries that have experienced particularly large booms and busts in property development. Authorities in some jurisdictions have been concerned about forbearance of property (and other) loans by banks, such as by extending loan maturities or converting loans to interest-only terms. These actions help borrowers cope with temporary periods of financial distress and avoid the need for banks to sell assets into already depressed markets. However, they could leave banks under-provisioned if economic and financial conditions turn out weaker than expected. The slowing in economic activity in

Graph 1.15
US Non-performing Loans*
Per cent of loans



Graph 1.16
Property Price Indicators
31 December 2002 = 100



some of these countries since mid year suggests an increasing likelihood that this risk will be realised.

Over the longer term, it is likely that banks and the investor community will need to lower their return expectations. Many banks need to continue to increase their common equity positions to meet the Basel III requirements, and in some cases, the extra capital buffers that the Financial Stability Board and Basel Committee on Banking Supervision have proposed to apply to global systemically important banks (see the 'Developments in the Financial

System Architecture’ chapter). While this should make them more resilient, it means their returns over the medium term are likely to be lower than before the crisis. Capital positions will need to be built up partly via banks preserving a higher share of internally generated revenue than in the pre-crisis period – for example, by lowering dividend payout ratios or reducing the share of revenue paid to employees. But the task of revenue generation will also be challenged by a regulatory and supervisory framework that will, appropriately, limit bank risk-taking compared to the recent past. Although some large banks have lowered their target returns below the rates seen in the few years before the crisis, in many cases these targets remain high when compared with returns achieved over a longer period. If banks and their investors continue to target unrealistic returns, then they may take on risks that could ultimately sow the seeds for future financial distress.

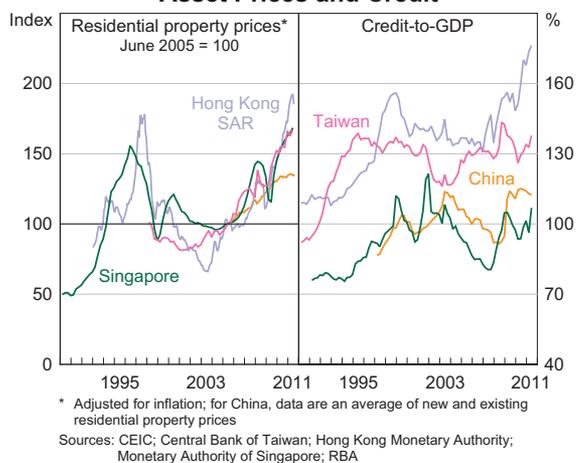
Banking Systems in Emerging Asia

Banking systems in the emerging Asian region remain in much better shape than many of those in the major advanced economies. While Asian banks were not completely immune from the global financial and economic strains during the crisis, their focus on strongly growing domestic banking markets and their relatively low reliance on offshore wholesale funding sources partly insulated them. They largely avoided building up portfolios of the types of structured securities that banks in the North Atlantic region have had to write down. As such, with a few exceptions, banks in the Asian region did not require public sector capital support. Given their domestic focus, Asian banks are well placed to cope with the current market stresses stemming from the sovereign debt problems in Europe, because they have little direct exposures to euro area sovereigns or banks. However, spillovers to Asian economies and their banking systems may occur if some large European banks are forced to reduce their exposures in Asia.

The profitability of the large Asian banks has generally remained strong in 2010 and early 2011, with after-tax returns on equity ranging from about 10 to 25 per cent, around the rates seen in the years leading up to the financial crisis. This compares with lower post-crisis average returns of around 5 to 10 per cent for large banks in the United States, United Kingdom, and the euro area. Asian banks’ profitability has been supported by robust growth in deposits and lending amid strong economic conditions and high domestic saving rates.

Real interest rates in some fast-growing Asian economies have remained low or negative for some time, despite gradual policy tightening. Credit has therefore expanded at a strong pace over recent years, contributing to significant rises in asset prices in a few countries. Residential property prices in Hong Kong, Taiwan, Singapore and some large cities in China have increased considerably (Graph 1.17). If property prices were to unwind, credit quality could decline. Banks’ exposures to property development companies would be most problematic in such a scenario: lending standards for residential mortgages tend to be relatively conservative and have been tightened by supervisors in some countries in recent years. Regulatory impositions for mortgages have

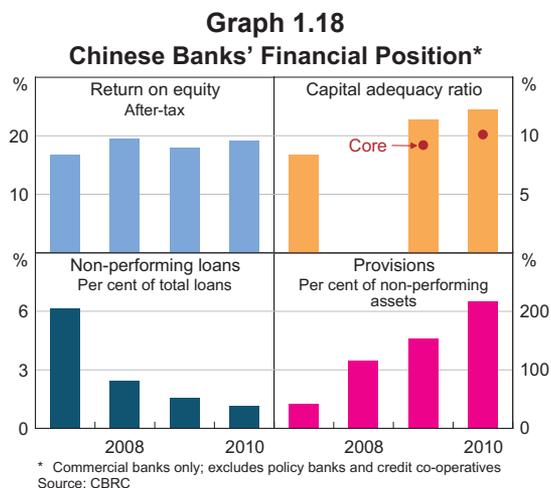
Graph 1.17
Asset Prices and Credit



included increases in minimum down-payment requirements, and introducing or increasing taxes on certain property sales.

The Chinese authorities, in particular, have sought to tighten credit conditions over the past year or so. They have raised banks' required reserves and imposed strict controls over lending, including restrictions on lending for mortgages and to local government entities. It is thought that some of the lending to local governments over recent years was directed to projects that are not commercially viable, which raises asset quality concerns. According to recent estimates by the Chinese national auditors, bank loans to local governments as at the end of 2010 were equivalent to around 20 per cent of GDP, or 10 per cent of banking system assets. Despite these policy actions, however, various forms of off-balance sheet lending (such as bank-accepted bills) have continued to grow strongly. Including off-balance sheet credit, the overall credit-to-GDP ratio in China had increased to about 130 per cent by mid 2011 – a high ratio relative to countries at the same per capita income level.

At this stage, Chinese banks' loan portfolios have not deteriorated: the non-performing loan ratio for all commercial banks fell over 2010, to 1.1 per cent, its lowest level since at least prior to the Asian financial crisis in the late 1990s (Graph 1.18). More recent data indicate that the non-performing loan ratios of the five largest banks (which represent around one-half of Chinese banking sector assets) declined further over the first half of 2011. The Chinese supervisory authority has required banks to increase their provisions and capital buffers over recent years, measures which should help banks deal with any future increase in problem loans. Chinese banks' aggregate core Tier 1 capital ratio was 10 per cent at end 2010 – a higher ratio than in many advanced economy banking systems, but low relative to other Asian banking systems that are also experiencing strong credit growth.

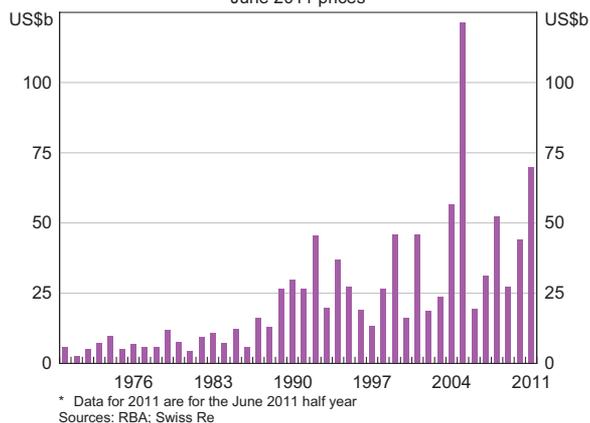


Recent Catastrophe Losses of Insurers

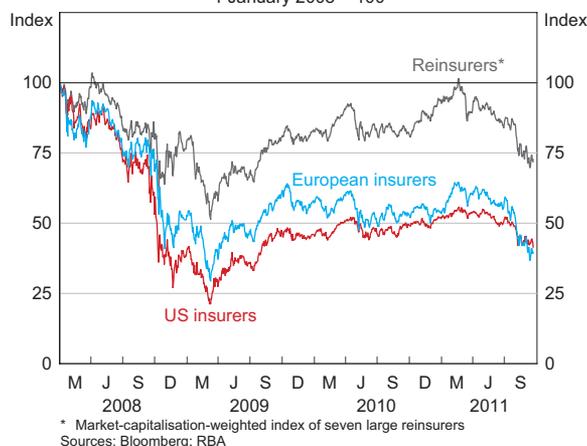
The global insurance industry has been challenged by a spate of natural disasters in 2011. Insured losses from catastrophes in the first half of 2011 are estimated to be around US\$70 billion, more than double that in the first half of 2010 and around five times higher than the six-monthly average of the previous decade (Graph 1.19). The high losses are largely due to the earthquake and tsunami in Japan: insured losses from this event are estimated to be around US\$30 billion, which would make it the costliest natural disaster for insurers after Hurricane Katrina in the United States in 2005. Insured losses from the February Christchurch earthquake, and the floods and Cyclone Yasi in Queensland, are estimated to be around US\$10 billion and US\$3½ billion, respectively.

Claims from the recent natural disasters have adversely affected the profitability of large global reinsurers, which reported a small aggregate net loss in the first half of 2011, equivalent to an annualised after-tax return on equity of about -½ per cent (see 'Box B: The Global Reinsurance Industry'). These reinsurers were able to easily absorb these small losses and maintain high capital buffers. The largest global general insurers – AIG, Allianz and Zurich Financial

Graph 1.19
Global Catastrophe Insurance Claims*
 June 2011 prices



Graph 1.20
Insurers' Share Prices
 1 January 2008 = 100



Services – also reported elevated catastrophe losses in the first half of 2011, though they all remained profitable because of favourable results for their non-catastrophe insurance operations. A couple of the large European insurers and reinsurers have also recorded sizeable impairments on their exposures to Greek debt in the most recent period.

Globally, share prices of insurance and reinsurance firms have fallen more sharply than the broader market since the start of August (Graph 1.20). This likely reflects their sizeable sovereign exposures and, more generally, market concerns about the adverse impact of renewed debt and equity market volatility on insurers' investment portfolios, rather than their insurance operations. If this volatility were to continue, investment losses could reduce insurers' profits. An additional risk to their future profits would emerge if the current US hurricane season were particularly severe, as this would generate further significant catastrophe losses and may place pressure on some insurers' capital reserves. Insured losses from Hurricane Irene in the United States in late August are not expected to be as high as those from major catastrophe events earlier in 2011, with initial estimates around US\$2–7 billion.