

Research note

25 September 2009

Financial Stability Review: Who's better, who's best

- The RBA is more optimistic on both the financial system and the economy than six months ago, but challenges are still ahead.
- The big test will be when the stimulus for the economy and bank guarantees are removed.
- The RBA sees a high probability of increased regulation in the global banking system, but is concerned that changes to regulation could lead to avoidance tactics as costs rise.
- The RBA is still positive on the economy, but the next quarter is a challenge.
- Concerns remain over the commercial property sector and credit rationing.

RBA signals returning stability

In the latest six-monthly *Financial Stability Review*, the Reserve Bank of Australia (RBA) stated that “conditions in the global financial system have improved significantly since the time of the last *Financial Stability Review* in March. While markets remain under a degree of stress, the extreme risk aversion that broke out following the Lehman Brothers collapse last September has dissipated, and confidence has begun to recover. These developments have occurred alongside signs of improved prospects for recovery in the global economy.”

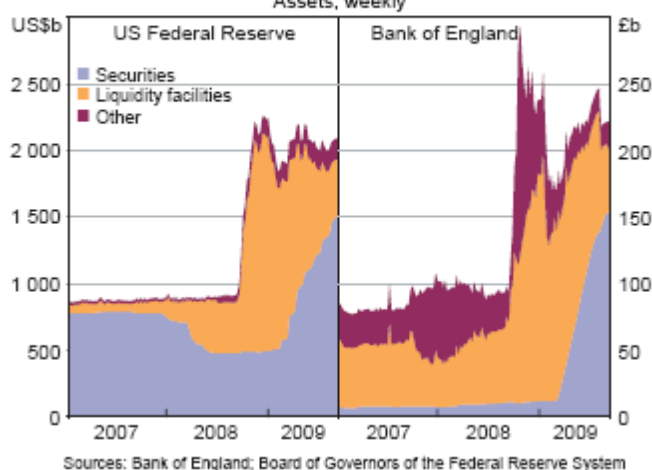
More specifically on Australia the RBA noted “the Australian financial system has, throughout the crisis period, remained resilient. In aggregate, the Australian banks have experienced only a modest decline in profitability. While there has been some diversity of performance across banks, increases in loan losses and impairments across the banking system to date have been lower than in many other countries. The banks are well capitalised and have strengthened their balance sheets further with significant new equity raisings during the past year.”

Improvement in credit markets, but not back to normal

The RBA has also highlighted a number of key issues for the Bank and financial system:

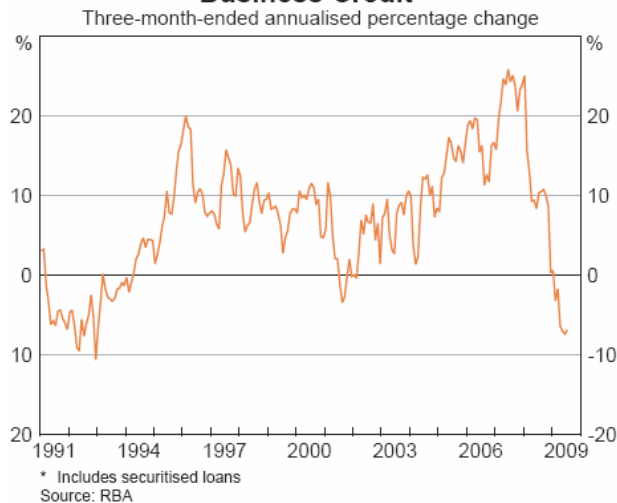
- A large part of the improvement in credit markets is due to government policy intervention, but policy settings are far from normal.
- The stimulus implemented over the past 12 months, including government guarantees, needs to be withdrawn at some stage and the RBA remains unsure how the market will deal with this.
- One part of a return to more normal financial market and economic conditions is a return to bank profitability. So far banks (in the US, less so in Australia) have made profits following easy comparatives after write-downs.
- As shown in the chart below, the balance sheets of major central banks remain highly elevated.

Graph 17
Central Bank Balance Sheets
Assets, weekly



- Credit is still being rationed in Australia, especially in the business sector, see chart below.
- The weighted average cost of capital has clearly risen. This will be a factor weighing on banks for some time yet.

Graph 78

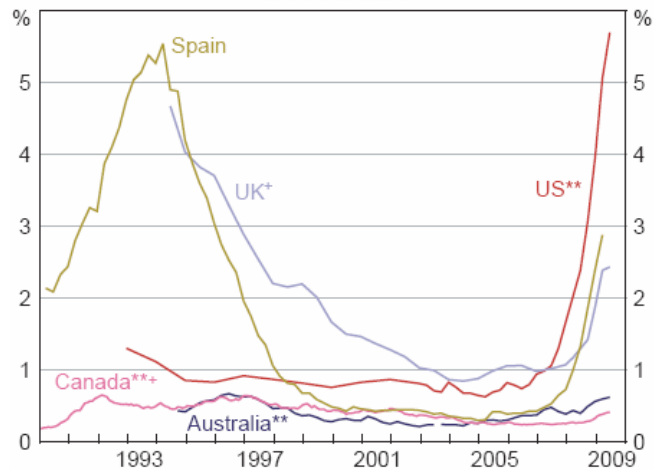
Business Credit***Australian Banks in good shape**

- The Australian banks are in good shape given solid balance sheets and only a small tick up in mortgage defaults.
- This has been helped by the transmission mechanism of monetary policy in Australia, with the benefits of lower official interest rates being passed onto customers, and helped by the relatively benign increase (so far) in the unemployment rate.
- If there is a concern about Australian banks, it is around the ability to continue to attract offshore funding to ensure a reasonable amount of credit growth continues in Australia to support economic growth. If this falters, banks will need to ensure there is enough domestic credit creation and will rely more on deposit funding. There are issues on the capacity of households and businesses to increase leverage.
- Some concern has been expressed about house prices in Australia on price to income metric. But this has continually been proved wrong.
- As per charts below, defaults on housing lending in Australia has picked up over the past year or so, but at around 0.6% remains extraordinarily low when compared with other major nations, such as the US (over 5.5%), Spain (2.9%) and the UK (2.5%).

Graph 32

Banks' Non-performing Loans

Graph 35
Non-performing Housing Loans
 Per cent of loans*

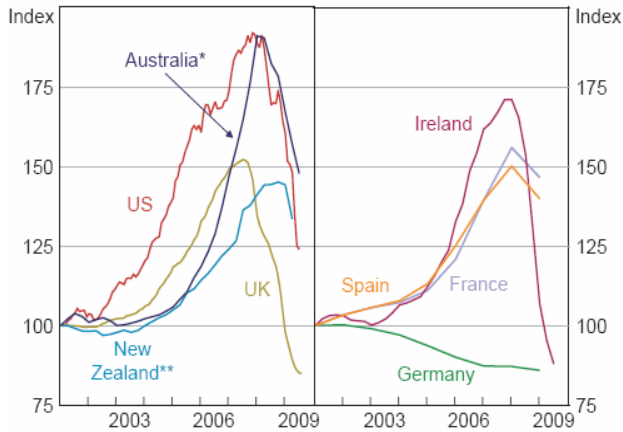


* Per cent of loans by value. Includes 'impaired' loans unless otherwise stated. For Australia, only includes loans 90+ days in arrears prior to September 2003.
 ** Banks only.
 + Per cent of loans by number that are 90+ days in arrears.
 Sources: APRA; Bank of Spain; Canadian Bankers' Association; Council of Mortgage Lenders; FDIC; RBA

Concern over the commercial property sector

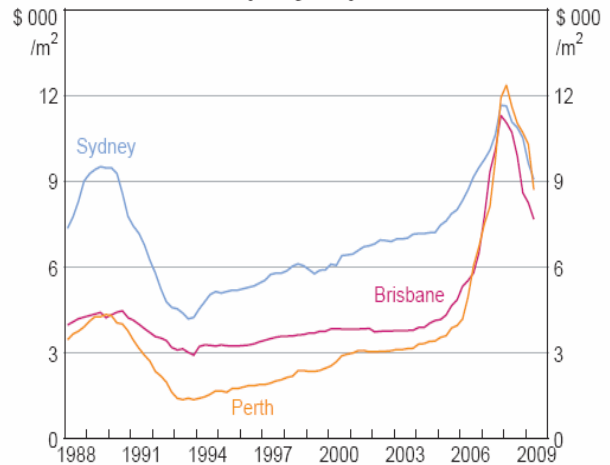
- The RBA still has concerns over the commercial property sector. Losses in this sector can take years to come through and could still hurt banks. The charts below show the falls in commercial property to date internationally and in Australia.
- Although the situation is not as bad as 1990s, this is likely due to less supply build up.

Graph 25
Commercial Property Prices
 December 2000 = 100



* Prime office space only
 ** Seasonally adjusted
 Sources: Bloomberg; Jones Lang LaSalle; RBA

Graph 83
Office Property Capital Values



Sources: Jones Lang LaSalle; RBA

Changes to regulation

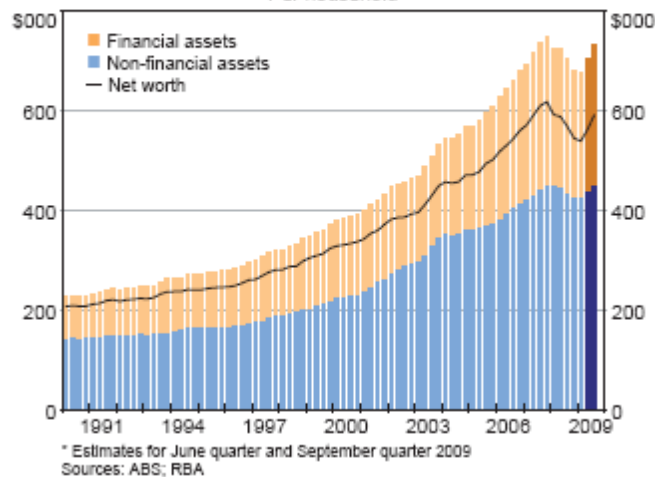
- The RBA has clearly indicated that they expect that one outcome of the global financial crisis will be changes to regulation.
- Much of this will be centred on lifting the amount of capital banks will need to hold.
- This could take various forms and could include counter cyclical capital buffers, tougher liquidity tests and systemic capital requirements.
- This increase in regulation will make financial intermediation more costly. The big worry is that this could lead to avoidance behaviour, with credit provided outside the regulated system.

- Concerns remains that post the recovery from the financial crisis that credit growth will be slower and this could lead to slower economic growth. However, the RBA likely has no real desire to target credit growth as part of monetary policy setting as this is too problematic.
- However, the RBA has made the point that higher capital ratios in the US prior to the crisis would not have prevented the crisis.
- The hope from the current G20 meeting is that any changes to regulation will be implemented after there is a sustained global economic recovery. Any changes before this could dampen the recovery.

On the Australian economy

- As shown in the chart below, Australian household net worth has started to improve again, after significant falls over 2008.
- The RBA has noted that “overall borrowings by households has continued to expand over the past couple of years, though the pace of growth has moderated. Lending for owner-occupied housing has picked up noticeably since the start of the year in an environment of low interest rates, first-home owner incentives and improving confidence. The increase in borrowing has been associated with firmer conditions in the market for established housing.”
- However, the RBA has also stated that “borrowing by businesses from financial institutions has been declining since late last year. This has reflected both reduced demand for credit in the current environment and, to some extent, tighter lending standards. While most businesses entered the crisis period with sound balance sheets after a long period of economic expansion, the climate of uncertainty over the past year has prompted many of them to strengthen their balance sheets, by taking advantage of the recovery in equity markets to raise additional equity.”
- The RBA has also indicated that the re-emergence of a two speed Australian economy (ie strong resources, but weaker elsewhere), does not present a significant challenge for monetary policy, but it does make it harder to sell the message.
- The RBA has noted that the last two or three months of economic data has not been as good as the few months before that, but the real test for the Australian economy will be the Q4 09, to see if there is a sustained recovery following the government stimulus packages and RBA rate cuts.

Graph 62
Household Assets and Net Worth*
Per household



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