Overview

Risks in the global financial system have shifted in the past six months. Advanced country banking systems have recorded improving asset quality and capital positions. The recent rise in premia in some financial markets suggests that investors are becoming more discerning about risk, but search for yield behaviour is still evident in a range of asset markets where prices remain elevated. Although concerns about Greece came to a head in the middle of the year during the protracted negotiations with its creditors, there was little spillover to other countries' financial systems partly because European bank exposures to Greece have been wound back.

Attention has instead shifted to China and other emerging market economies. The growth outlook for a number of these economies has deteriorated against a backdrop of higher debt; in addition, lower commodity prices, fiscal pressure and political instability are compounding the situation in some cases.

These concerns have precipitated a pick-up in financial market volatility in emerging and advanced economies. There have been sizeable fluctuations in some equity and currency markets, with the large run-up in Chinese equity prices that began in 2014 now substantially reversed. The price movements in some financial markets, including in advanced economies, have, on occasion, been amplified by short periods of trading disruption, underlining concerns that some investors might be under-pricing liquidity risk. With the US Federal Reserve's first tightening since 2006 in prospect, the risk is that this combination of factors could trigger a sharp repricing in markets. However, while adding volatility to some markets in Australia, to date these global factors have not had a material impact on Australia's financial system.

The domestic risks to financial stability in Australia continue to revolve mainly around developments in some local property markets. The risks surrounding housing and mortgage markets seem higher than average at present. Housing markets have been buoyant in Sydney and Melbourne over much of the year, with very strong price growth and a historically large role being played by investors. The recent enhanced scrutiny of lending practices following reviews by the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC), along with substantial data revisions by banks, has shown that the level of investor activity was in fact higher over recent years than had originally been thought.

For several years, overall mortgage lending standards have been tighter than they were in the lead-up to the global financial crisis: 'low-doc' loans are rare; genuine savings are expected to fund at least part of the deposit; and it is now common practice to apply a buffer to the interest rate when calculating allowable loan sizes. However, lending standards appear to have been somewhat weaker around the turn of this year than had been apparent at the time, or would be desirable in the current risk environment. Standards have since been tightened. This was in part necessary because nominal housing price growth might be expected to be slower on average – and periods of absolute price declines to be more common – now that the earlier transition to a low-inflation, higher-debt state has been completed. The recent tightening should therefore be understood as addressing the need for a permanently stronger level of lending standards, as well as reversing some of the slackening in serviceability standards that had started to occur in response to strong lending competition.

Risks have been growing in commercial lending related to property, which historically has been a common source of financial instability both domestically and abroad. Building approvals for new apartments have remained very strong over 2015, even though rental markets already look soft in some areas and the projected growth of net international student arrivals has been revised down. The divergence between commercial property valuations and rents has widened further, with strong local and foreign investor interest for new and existing office buildings in particular, even though vacancy rates are quite high. At the same time, falling commodity prices are weighing on the profitability of many resource-related companies, though the rest of the business sector looks to be in fairly good shape. In this context, the deterioration in New Zealand's dairy sector in response to low global milk prices will be an area to watch, given the size of the Australian bank subsidiaries' exposures to that sector.

These risks appear to be comfortably manageable at this stage, but they underscore the need to maintain sound lending standards and the resilience of the financial and non-financial sectors. As noted, most banks have now strengthened the serviceability metrics used in their mortgage lending and taken steps to slow the pace of growth in investor lending towards APRA's expectations. Banks also report that they are becoming increasingly wary of lending to property developers in markets that look oversupplied. The large banks have enhanced their resilience recently by raising substantial amounts of fresh capital in advance of new prudential requirements. Many households have likewise been bolstering their resilience in a number of ways, including paying down their debt faster than contractually required and increasing their offset account balances.

Nonetheless, competition among lenders remains strong in the owner-occupier part of the mortgage market and in parts of the business lending market. Looking ahead, a key challenge will be to ensure that, in an environment of low interest rates, lending standards at both Australian and foreign-owned banks do not weaken materially from here. Over the medium term, it will also be important to monitor how banks respond to the wide range of ongoing international and domestic regulatory changes.

The responses of banks to the housing-related prudential measures announced last December have evolved over the course of the year, and the effects of some of the most recent actions undertaken by the banks, such as increasing pricing on some types of housing loans, will not yet be fully apparent in published data. Nonetheless, some indicators of housing demand, including the growth of investor credit, have moderated of late; in particular, there are a few tentative signs that sentiment may be turning in the housing markets of the two largest cities. Assuming that these early signs of a better risk profile in the housing market are borne out in future data, this would imply that the household and banking sectors are becoming better placed to manage the risk environment than they were a year or so ago.