

Overview

The global financial system continues to be buoyed by strong investor risk appetite. International financial markets have been remarkably stable for much of the past six months, with historically low volatility and ‘search for yield’ behaviour evident in many asset classes amid highly expansionary monetary policy. This environment has supported economic growth and an ongoing improvement in most banking systems. Nonetheless, a significant reassessment of risk could lead to a sharp repricing of assets, particularly if markets are less liquid than anticipated. Potential triggers for such a reappraisal include revised expectations for monetary policy in advanced economies. Up to this point, however, market prices have reacted remarkably little to credit and geopolitical events that might have been expected to affect investor risk appetite.

Risks surrounding European banks and sovereigns have lessened but not disappeared, given the slow growth environment. European banks have made some progress with balance sheet repair in the lead-up to the release of the European Asset Quality Review, though if the results are unexpectedly negative, it could impede these banks’ ability to raise additional capital. Conditions in many emerging markets have stabilised since early 2014. However, credit and property prices have grown strongly in some emerging economies, including China, which may have made these economies more sensitive to adverse shocks.

Financial system stability in Australia is being underpinned by the continued strong financial performance of the banking system. Australian

banks have improved their resilience to future shocks by increasing capital ratios, and their profitability remains robust, aided by further declines in bad and doubtful debt charges. They are also benefiting from improved wholesale funding conditions globally. This in turn has put downward pressure on deposit pricing and fostered an environment of stronger price competition in lending. Non-banks are also benefiting from the lower funding costs, with issuance of residential mortgage-backed securities by a wider range of entities (including mortgage originators) picking up and associated spreads narrowing.

The low interest rate environment and, more recently, strong price competition among lenders have translated into a strong pick-up in growth in lending for investor housing – noticeably more so than for owner-occupier housing or businesses. Recent housing price growth seems to have encouraged further investor activity. As a result, the composition of housing and mortgage markets is becoming unbalanced, with new lending to investors being out of proportion to rental housing’s share of the housing stock. Both construction and lending activity are increasingly concentrated in Sydney and Melbourne, where prices have also risen the most.

In the first instance, the risks associated with this lending behaviour are likely to be macroeconomic in nature rather than direct risks to the stability of financial institutions. Property investors in Australia have historically been at least as creditworthy as owner-occupiers, and mortgage lending standards remain firmer than in the years leading up to the

financial crisis. Even so, a broader risk remains that additional speculative demand can amplify the property price cycle and increase the potential for prices to fall later, with associated effects on household wealth and spending. These dynamics can affect households more widely than just those that are currently taking out loans: the households most affected by the declines in wealth need not necessarily be those that contributed to heightened activity. Furthermore, the direct risks to financial institutions would increase if these high rates of lending growth persist, or increase further. In this environment, recent measures announced by the Australian Prudential Regulation Authority (APRA) should promote stronger risk management practices by lenders. The Bank is discussing with APRA, and other members of the Council of Financial Regulators, additional steps that might be taken to reinforce sound lending practices, particularly for lending to investors.

The dynamics in the housing market are also relevant in considering risks in commercial property markets. This area of Australian business activity has strengthened over the past couple of years, unlike most other parts of the business sector. Amid the global search for yield, Australian commercial property has attracted strong investor demand, both domestic and foreign. This has boosted prices and widened the disparity between movements in prices and rents for both CBD office and industrial property. Any significant reversal of this demand could expose the market to a sharp repricing. At this stage, however, the broader risks to financial stability from this source remain modest, because banks' commercial property exposures are a smaller share of banks' total assets than prior to the crisis.

Conditions in other parts of the financial sector are generally favourable. General insurers' profitability remains strong overall, with the industry currently benefiting from a benign claims environment.

Buoyant conditions in the housing market have also contributed to stronger profits for lenders mortgage insurers. The part of the financial sector considered 'shadow banking' continues to decline as a share of financial system assets. It currently poses little systemic risk in Australia because of its small size and limited credit and funding links to the regular banking system.

As G20 Chair for 2014, Australian authorities – including the Reserve Bank – have continued to work with the Financial Stability Board towards substantially completing key aspects of four core areas of reform: building resilient financial institutions through the Basel III reforms; addressing the 'too big to fail' problem associated with systemically important financial institutions; responding to shadow banking risks; and making derivatives markets safer. Progress appears largely on track to achieve, by the November G20 Leaders' Summit, the key deliverables set out at the start of the year. However, achieving these high-level agreements would still leave some challenging areas of detail to be worked out, particularly on aspects of 'too big to fail' and derivatives markets reform.

The Financial System Inquiry released its wide-ranging *Interim Report* in July. While the report offered a largely favourable assessment of the current financial regulatory framework, it did highlight some areas for improvement, including potential measures to promote increased coordination among regulators. The Bank made a second submission to the Inquiry, covering areas related to financial stability and the responsibilities of the Reserve Bank, particularly for the payments system. ❖