

Overview

Developments in advanced economy financial systems have been broadly favourable over the past six months, while conditions in some emerging market systems deteriorated somewhat. Conditions in most major banking systems have continued to improve in line with better economic outcomes. In the United States, the improving economic outlook has seen the Federal Reserve take initial steps towards normalisation of monetary policy. This is a positive development for financial stability, not least because a sustained period of highly stimulatory monetary policy can create incentives for excessive risk-taking by investors. Nonetheless, there are also risks associated with exiting from highly accommodative monetary policy, as rising yields may expose risk among investors and borrowers, trigger heightened volatility in financial markets and weigh on economic growth if market interest rates overshoot.

Ongoing fragilities in the euro area could disrupt the nascent recovery there if investor sentiment were to deteriorate more broadly. Against a background of weak bank profitability and worsening asset performance, a key event for the euro area in 2014 is the European Central Bank's comprehensive banking system review. While the review should ultimately assist in restoring market confidence in the euro area banking system and promoting bank balance sheet repair, there could be renewed disruption if major capital shortfalls are uncovered before there is a European resolution fund in place to shield sovereigns from their banking sectors.

Market concerns about vulnerabilities in some emerging markets, which initially arose around the middle of last year, returned in late January. However, these were focused largely on country-specific issues and uncertainty about the outlook for the Chinese economy, rather than representing an across-the-board retreat from risk-taking. In 2013, large moves in equity prices and exchange rates were observed in economies with some combination of larger current account deficits, lower foreign currency reserves and building inflation pressures, while in the most recent episode of volatility, differences in growth prospects and domestic political circumstances have featured prominently. For most emerging market economies, however, capital outflows have been more moderate and asset price adjustments have reflected a degree of normalisation, following a long period of accommodative financial conditions. The prospect of direct financial contagion to advanced economies is limited to some extent by the small exposure that advanced economy banking systems have to emerging markets.

The Australian banking system continued to perform strongly in 2013. Asset performance has been gradually improving and, in line with this, bad and doubtful debt charges have declined, supporting profitability. The four major banks appear well placed to use internal capital generation to meet the higher capital requirements that they will face from 2016, having been designated by the Australian Prudential Regulation Authority (APRA) as domestic systemically important banks. From 2015, banks will need to

meet APRA's new liquidity requirements, which are designed to strengthen a bank's ability to deal with liquidity pressures. While banks have reappraised their funding structures more generally since the financial crisis, the new liquidity rules will continue to influence the composition of banks' liabilities in the lead-up to the January 2015 start date.

Profitability in the general insurance industry remained strong over 2013, supported by premium increases and relatively fewer natural disasters than in recent years. Within the industry, the performance of lenders mortgage insurers remained somewhat softer than other general insurers, though it did improve in the second half of 2013, reflecting lower claim expenses.

With banks' bad and doubtful debt charges now at relatively low levels, and in an environment of moderate credit growth, the sources of profit growth may be more limited in the period ahead. It will be important for financial stability that banks do not respond by unduly increasing their risk appetite or relaxing their lending standards. One area that warrants particular attention is banks' housing loan practices. While rising housing prices and greater household borrowing are expected results from the monetary easing that has taken place and are helping to support residential building activity, they also have the potential to encourage speculative activity in the housing market. Lending to both housing investors and repeat-buyer owner-occupiers has been increasing for some time in New South Wales and has also picked up in some other states over the past six months. The pick-up in lending for housing would be unhelpful if it was a result of lenders materially relaxing their lending standards. Although current evidence suggests that lending standards have been broadly steady in aggregate, there are indications that some lenders are using less conservative serviceability assessments when determining the amount they will lend to selected borrowers. It is important for both investors and owner-occupiers to understand that a cyclical upswing in housing prices when

interest rates are low cannot continue indefinitely, and they should therefore account for this in their purchasing decisions.

More generally, the overall financial position of the household sector was little changed in 2013 and indicators of financial stress generally remain low. Households continued to manage their finances with greater prudence than a decade ago: household wealth continued to increase; the saving ratio was within its range of recent years; and households continued to pay down mortgages more quickly than required. However, with household gearing and indebtedness still around historical highs and unemployment trending upwards, continued prudent borrowing and saving behaviour is needed to underpin the financial resilience of households. The recent momentum in household risk appetite and borrowing behaviour, in particular, therefore warrants continued close observation.

Indicators of distress in the business sector, such as failures and non-performing loans, generally continued to ease through 2013 and conditions appear to have improved. The period of deleveraging that took place following the financial crisis appears to have run its course, though the overall need for external funding by businesses, including demand for credit, remains modest. In the commercial property market, there appears to be increased interest from investors, particularly in the office property segment, where CBD prices have been rising in several cities despite weaker rents. This is consistent with some investors searching for higher yields, particularly relative to major overseas markets and other investments.

The involvement of Australia in international efforts to reform the global financial system, through the G20, the Financial Stability Board and standard-setting bodies, has increased further with Australia taking on the role of Chair of the G20 late last year. As part of this, Australia has worked to sharpen the focus of the G20's financial regulatory efforts in 2014 on substantially completing key aspects of the four core reform areas in response to the crisis:

building resilient financial institutions through the Basel III reforms; addressing the 'too big to fail' problem; addressing shadow banking risks; and making derivatives markets safer. While there are certain aspects of the reforms that are still being finalised (at both global and national levels), attention of the global bodies is turning increasingly to implementation by national authorities and assessments of consistency in implementation globally. One example of this is the recent review by the Basel Committee on Banking Supervision of APRA's capital standards to assess their consistency with the Basel capital framework; APRA's standards were found to be compliant overall, with 12 of the 14 key components assessed as compliant and the other two as largely compliant.

The Australian financial system is also being reviewed under the government's Financial System Inquiry that was established late last year. The terms of reference for the inquiry are broad-ranging, covering aspects such as: the consequences of developments in the Australian financial system since the 1997 inquiry and the global financial crisis; the philosophy, principles and objectives underpinning the development of a well-functioning financial system; and the emerging opportunities and challenges that are likely to drive further change in the global and domestic financial system. The Bank will make a detailed submission to the inquiry shortly. ✎

