

Overview

The main risks to the global financial system have shifted somewhat over the past six months. In the euro area, which has been a significant source of uncertainty in recent times, there have been some positive policy developments as well as early signs of an improved economic outlook. However, profitability of the euro area banking system remains weak and non-performing loan ratios continue to rise. A number of banks in the euro area still cannot access wholesale funding markets. Thus there is still a chance that negative outcomes in that region could harm global financial stability.

Financial market volatility has increased, particularly in the middle of the year when the Federal Reserve indicated that it could begin scaling back its asset purchase program later this year, which triggered a rise in yields and declines in prices of a range of risk assets. Market sentiment improved subsequently and many risk assets have partially unwound their initial price declines. The higher yields have remained and have acted to curtail somewhat the amount of risk-taking by investors, which had previously been a source of concern to some policymakers. Geopolitical tensions arising from events in Syria, which led to a sharp rise in oil prices, demonstrate that negative shocks to markets can arise from a range of sources, and their timing generally cannot be anticipated.

In the context of this increase in volatility, some points of pressure have arisen in a few emerging markets, partly reflecting the earlier build-up in borrowing. The reversal of some previous capital inflows, and exchange rate depreciations, have

focused attention on the potential for losses from foreign currency borrowing and lending, especially in fast-growing financial sectors where credit risk has perhaps been building. That said, indicators of vulnerability in these economies are generally not as high as in earlier periods of stress. Banking systems in Asia, in particular, remain quite profitable and well capitalised, and their reported non-performing loan ratios remain low. Risks in 'shadow banking' sectors are generally harder to ascertain, but in China at least, a number of the sectors within the fast-growing shadow banking system face increased regulatory oversight.

Conditions in major banking systems outside the euro area continue to recover, consistent with the macroeconomic outlook. Asset performance and profitability have been improving in the United States and the United Kingdom, and the recent increase in global bond yields from historically low levels has so far not revealed any funding stresses. As in the euro area, credit growth remains very slow in both countries, despite policy measures to ease credit supply.

The Australian banking system continues to perform relatively well. Banks were in a good position to meet the Basel III capital requirements, which the Australian Prudential Regulation Authority (APRA) began phasing in from the start of the year. Given this, the major banks moderately reduced the pace at which they accumulated common equity in the past year by increasing their dividends. The major banks' profitability remains strong, partly supported by cost-cutting initiatives, while the aggregate

profitability of the regional banks is expected to recover following some one-off sales and write-offs of troubled portfolios. The relatively modest rate of growth in credit, and hence bank balance sheets, poses a strategic challenge for Australian banks. Of particular importance is that banks maintain prudent risk appetite and lending practices, especially in the current low interest rate environment.

Another focus for the industry in the period ahead will be implementing APRA's forthcoming liquidity standard, which puts into effect key elements of the Basel III liquidity framework in Australia. The planned introduction of this standard, together with market pressures, has encouraged banks to strengthen their funding and liquidity positions over recent years.

Alongside Basel III, international regulatory reforms are affecting Australia's financial market infrastructures. In particular, the transition of standardised derivatives to central clearing has gathered pace over the past six months, and it is expected to continue to do so as the provision of these services expands.

The general insurance sector is facing some challenges from the low interest rate environment, notably for their investment income. General insurers have nonetheless remained quite profitable, partly reflecting a favourable claims experience. Although lenders mortgage insurers have recently seen higher than average claims and lower profits, insured loans originated in the past few years have been performing quite well.

Conditions in the Australian business sector, as reported in surveys, have remained a little below average over the year to date. In addition, business failure rates remain above average, but business balance sheets are in good shape overall. The period of deleveraging following the global financial crisis appears to have largely run its course, but at this stage, gearing ratios in the listed corporate sector are only slightly above their recent troughs. Profitability is expected to improve somewhat over this financial year and the depreciation of

the Australian dollar since the beginning of the year should help ameliorate the challenges faced by some trade-exposed sectors in recent years. While conditions in the commercial property leasing market appear to be softening, prices have continued to increase because of strong investor demand.

Australian households continue to show more prudence in managing their finances than a decade ago. The higher rate of saving and slower pace of credit growth have been in place for some time now, although surveys of households suggest that their risk appetite has increased a little, as would be expected in an environment of low interest rates and recovering asset prices. The risk profile of new household borrowing remains reasonably sound and indicators of household financial stress are low. The continued high rate of excess repayments on home loans is consistent with low rates of financial stress among households with mortgages.

Over the past year or so there has been an increase in property market activity. This is not surprising given the reductions in interest rates. The pick-up in demand, which has been sharper in New South Wales and from investors more generally, has been associated with recent increases in housing prices. It is important that those purchasing property do so with realistic expectations of future dwelling price growth.

In this issue of the *Review*, a particular focus has been placed on the self-managed superannuation fund (SMSF) sector. Although this sector does not currently pose material risks to financial stability, it is important for the financial position of the household sector and has a number of aspects that warrant careful observation in the period ahead. Changes to legislation in recent years have permitted superannuation funds, including SMSFs, to borrow for investment, for example to purchase property. Since then, property holdings by SMSFs have increased and this type of investment strategy is being heavily promoted. The sector therefore

represents a vehicle for potentially speculative demand for property that did not exist in the past. SMSFs and other retail investors have also been the dominant class of purchasers of hybrid securities recently. These investors seem to have been attracted by the higher yields offered on hybrids compared with conventional debt securities; it is important that they fully appreciate and price in the risks embedded in these more complex products.

The policy development phase of the international regulatory reform process generally remains on track with agreed time frames. However, implementation of some initiatives has been delayed in some jurisdictions. Accordingly, international regulatory efforts are increasingly focused on implementing reforms and assessing progress through peer review. Efforts to end the 'too big to fail' problem by improving cross-border resolution and crisis

management procedures have faced particular difficulties, partly because these reforms require legislative change in some jurisdictions. Cross-border issues have also complicated implementation of reforms in over-the-counter (OTC) derivatives markets. Authorities are working on an approach that avoids subjecting institutions and transactions to multiple – and possibly conflicting – sets of rules.

In Australia, recent actions to implement these reforms include steps taken by APRA, the Australian Securities and Investments Commission and the Reserve Bank around OTC derivatives market reforms relating to trade repositories and central clearing. APRA has also progressed on Basel III reforms, including issuing a revised draft liquidity standard to implement key elements of the Basel III liquidity framework in Australia. ✎

