Overview

Global economic conditions strengthened further over the past six months, reducing some near-term risks to financial stability and improving the outlook for bank profitability. Despite the gradual withdrawal of monetary stimulus in the United States, financial conditions remain accommodative. There are concerns that the combination of low interest rates and low volatility in financial markets is promoting excessive risk-taking via a search for yield. Indebtedness and asset prices have also risen further in some countries, from already high levels, increasing the risk of a disruptive correction. A number of policy uncertainties and geopolitical risks persist, which, if they were to escalate, could trigger a reappraisal of asset valuations and a spike in volatility while also weighing on the economic outlook.

Risks remain elevated in China given high corporate debt levels and the prevalence of borrowing through opaque, less regulated channels. This has led to considerable credit, liquidity and contagion risks in the Chinese financial system. Recent regulatory measures have the potential to curb these risks over the longer term, but the authorities face a challenging transition away from growth strategies associated with rising debt. In Europe, stronger growth, regulatory developments and initiatives by banks have generally improved the resilience of the financial system, although vulnerabilities remain in some countries given still weak banking systems and high sovereign debt.

Turning to Australia, household balance sheets and the housing market remain a core area of interest. Household indebtedness is high and, against a backdrop of low interest rates and weak income growth, debt levels relative to income have continued to edge higher. Steps taken by regulators in the past few years to strengthen the resilience of balance sheets, including limiting the pace of growth of investor lending, discouraging loans with high loan-to-valuation ratios (LVRs) and strengthening serviceability metrics, have seen the growth in riskier types of lending moderate. The most recent focus has been on limiting interest-only lending, and banks have responded by further reducing lending with high LVRs for interest-only loans, increasing interest rates for some types of mortgages and significantly reducing interest-only lending. The tightening of banks' lending standards for property loans is constraining some households and developers but, in doing so, making the balance sheets of both borrowers and lenders more resilient. Conditions are relatively weak in the Brisbane apartment market, with a large increase in supply reflected in declines in prices and rents. There are, however, few signs of significant settlement difficulties to date. More generally, while housing market conditions vary across the country, there are signs of easing of late, particularly in Sydney and Melbourne where conditions have been strongest.

Business conditions are generally favourable, although there are some concerns about non-residential commercial property markets. In Sydney, price increases continue to outpace the growth of rents for these properties. In contrast, activity is more subdued in some other cities and vacancies are elevated, especially in Perth. Conditions are positive in most other parts of the business sector, including the resources sector, as corporate profitability remains at a relatively high level and leverage and debt-servicing are contained. Business failures remain low.

The financial system is in a strong position and its resilience to adverse shocks has increased over recent years. Non-performing loans remain low in aggregate, though they are rising in some cities and regions that have a greater exposure to mining activity. Bank profitability is high and banks are seeking to maintain this by reducing their lower-yielding assets, both domestically and abroad. The banks also have ample access to a range of funding sources at a lower cost than a year ago, despite many of them being downgraded by credit rating agencies of late (largely due to concerns about high and rising household debt). The Australian Prudential Regulation Authority (APRA) recently announced details of its requirements for banks to have 'unquestionably strong' capital ratios. This will see a further rise in minimum capital requirements, so that the major banks are comfortably within the top quartile of international peers when measured on a comparable basis. Following further examples of lapses in risk controls, the government, regulators and banks are taking steps to enhance accountability and to strengthen the risk culture in the financial sector.

With the tightening of lending standards, there is a potential that riskier lending migrates into the non-bank sector. To date, non-bank financial institutions' residential mortgage lending has remained small though their lending for property development has picked up recently. While the banking system has minimal exposure to the non-bank financial sector, growth in finance outside the regulated sector is an area to watch.

The insurance sector has remained generally profitable, though returns on equity remain lower than historically and the sector continues to face a range of challenges over the medium to longer term. Risks to the superannuation sector are low in part due to its modest use of leverage. Financial market infrastructures have continued to function effectively.

Efforts to strengthen the resilience of the global financial sector are continuing, though the finalisation of the Basel III capital reforms has been delayed. International bodies have also been considering new potential sources of financial stability risk, including the growth of financial technology ('fintech') and cyber threats. They are also assessing the broad effectiveness of the post-crisis G20 financial reforms that have been implemented and whether there have been any material adverse developments that require adjustments to policies. Domestically, the Council of Financial Regulators has continued its work on enhancing the crisis management framework and on a range of other issues.