Overview

A number of risks continue to weigh on the outlook for the global financial system. In China, the level of debt is high and rising despite slower economic growth and signs of excess capacity in some areas; much of the new debt is being extended by the more opaque yet interconnected parts of its financial system. Non-performing loans (NPLs) are increasing, albeit off a relatively low base. While the authorities in China retain levers to support growth, using many of them would likely entail a further increase in debt that could increase the risks to longer-term reform and stability. Some other emerging market economies, especially commodity exporters and those with high levels of foreign currency-denominated corporate debt, face a varying mix of low commodity prices, lower exchange rates, slower economic growth and fiscal pressures. Private debt-servicing burdens have risen in some of these economies, and bond defaults have picked up, though banking systems in most emerging economies seem reasonably well placed to weather higher corporate defaults.

Conditions in the banking sectors of many advanced economies are also challenging. European banks' prospects remain mired in an unfavourable mix of low profitability, high NPLs and weak equity prices. While the recent stress tests of European Union (EU) banks highlight the gradual rise in capital ratios, the financial position of some Italian and other banks is weak. The vote in the United Kingdom to leave the EU led to significant volatility in many financial markets though, other than the UK pound, most prices largely recovered soon after. Low or negative interest rates continue to squeeze banks' net interest margins in Japan and elsewhere, and credit losses in the energy and related sectors have weighed on bank profits in some major countries. More generally, the ongoing low interest rate environment is boosting asset prices globally. Relatedly, housing prices in New Zealand have risen strongly, despite successive rounds of macroprudential measures; low milk prices are also weighing on prospects for New Zealand's dairy sector.

Domestic risks have continued to shift towards property development and resource-related areas. Risks to financial stability from lending to households have lessened a little over the past six months, as serviceability metrics and other lending standards have continued to strengthen and the pace of credit growth has slowed. Housing price growth is also slower than it was a year or so ago, although it has picked up a little in Sydney and Melbourne in recent months. The risk profile of new borrowing has improved further. The share of new high loan-to-valuation (LVR) lending and interest-only loans has fallen; high-LVR lending is now at its lowest share in almost a decade. Nonetheless, the household debt-to-income ratio is still drifting higher, even after adjusting for the rapid growth of balances in offset accounts. Non-performing mortgage loans have also picked up nationally but remain low. This pick-up has been most pronounced in mining areas where housing market conditions have deteriorated sharply, though only a small share of banks' mortgage lending is to these areas.

Risks around the projected large increases in supply in some inner-city apartment markets are coming to the fore, especially in Brisbane and Melbourne. There are signs that some settlements are taking longer and lending valuations are coming in below their contract price, though settlement failures to date remain low. Banks have recently tightened their serviceability requirements further by restricting lending to borrowers relying on foreign income; this might weigh on demand in some inner-city apartment markets. They have also taken steps to mitigate the associated risks by tightening lending conditions for new property developments. This could also help forestall future oversupply in some inner-city areas.

In office property markets, while yields in Australia and abroad have fallen in line with the global 'search for yield', weak conditions in Brisbane and Perth stand in contrast to the stronger performance in Sydney and Melbourne. Part of this divergence reflects lower demand for office space from resource-related firms in Brisbane and Perth. In contrast, there are few signs of stress in most other parts of the business sector.

Against these risks, the Australian banking system has continued to perform well and banks remain resilient to possible shocks. Bad debt expenses have risen from low levels, as performance has deteriorated for some exposures, namely lending to households and businesses in mining-reliant areas and to the New Zealand dairy sector. Profits have therefore declined a little. Capital and leverage ratios are high and the banks have bolstered their liquidity positions. Favourable conditions in external funding markets have allowed Australian-owned banks to issue sizeable amounts of wholesale debt. In response to higher capital levels and lower profits, the major banks have scaled back some international exposures. Furthermore, their exposures to the resource-related sector are small and falling; in contrast, the mining-related and commercial property exposures of the Asian banks operating in Australia remain high as a share of their assets. The insurance sector faces a range of challenges, though it is well capitalised.

Looking ahead, the regulatory environment for the global financial sector continues to strengthen as further elements of the Basel III capital and liquidity frameworks are put in place. Efforts are now shifting towards assessing the effects of these reforms on the financial system and the wider economy. Similarly, in Australia, the Australian Prudential Regulation Authority is seeking to ensure that the banks' capital ratios remain 'unquestionably strong' given their risk profile. Australian banks have responded by boosting capital levels and at the same time reducing their focus on lower-return activities to meet their return-on-equity expectations over the medium term. These developments will need to be closely watched to ensure that any behavioural changes do not materially increase systemic risk.