Overview

Global economic conditions have remained strong over the past six months, which has helped to further improve the health of the global banking system. However, a range of financial stability risks remain. Long-term government bond yields are still very low, despite generally increasing over the past year or so, which has continued to underpin elevated asset valuations and 'search for yield' activity. In addition, compensation for risk is low for many assets. Current asset pricing suggests that investors see little chance of adverse outcomes, and consequently a detrimental shock could lead to a disruptive and lasting correction in a broad range of markets. This could be triggered by a sharp rise in interest rates in the absence of stronger economic growth arising from, for instance, a jump in realised or expected inflation or a change in investors' risk appetite.

In China, the authorities continue to make concerted efforts to address risks in the financial system, and a range of further steps were announced over the past six months. This is a positive development because of the importance of the Chinese economy to the Australian economy. However, risks remain elevated given the rapid growth and high level of corporate sector debt as well as the complex and opaque nature of some parts of the financial system. The improving economic outlook in Europe is strengthening bank profitability, but the stock of non-performing assets in some countries remains high. In parts of Europe and elsewhere, household debt and housing prices remain high after earlier rapid growth.

On the domestic front, concerns about riskier types of new housing borrowing have eased. The prudential measures implemented over recent years have led to a general strengthening in lending standards, and the regulatory limits on investor loans and interest-only lending have reduced the build-up of macro-financial concerns.

The high level of household indebtedness increases the risk of a rise in household financial stress amplifying a shock to the economy. Most aggregate indicators of financial stress remain low. Some banks have reported that payment arrears have increased for some borrowers transitioning to principal-and-interest repayments at the end of an interest-only period. This partly reflects borrowers taking some time to adjust, though for a small share of borrowers this has reflected difficulty in making the higher repayments. Overall, however, the regulatory measures and broader strengthening of lending standards have contributed to an improvement in the risk profile of new housing lending and the resilience of household balance sheets. They have also contributed to the recent moderation in housing market conditions.

Conditions in commercial property remain an area to watch. It appears that the large stock of apartments reaching completion in Brisbane and other capital cities is being absorbed with little disruption to housing markets, though there have been some reports of settlement failures and delays. Non-residential commercial property prices in Sydney and Melbourne have risen further, with yields falling, in part reflecting ongoing 'search for yield' activity. In contrast, in the resource-intensive states conditions in office property markets remain challenging with elevated vacancy rates. More broadly, Australian-owned banks have slowed the growth in their commercial property exposures following a review by the Australian Prudential Regulation Authority (APRA) in 2016, though growth in lending by some foreign banks has remained strong. Lending by non-bank financial institutions to developers and households is growing strongly but remains a small share of total exposures. Conditions in the rest of the business sector continue to strengthen, with profits generally high and leverage contained, including for most firms in the mining-related sectors.

The resilience and overall financial performance of Australian banks has continued to improve. Profits in the second half of 2017 grew from an already high level, in part because of the increase in lending rates implemented by banks following the regulatory measures. Conditions in local and offshore long-term funding markets have also been generally favourable for banks, although there has been a recent rise in bank bill rates. Capital ratios have continued to rise and either already meet or are close to the 'unquestionably strong' targets announced by APRA last year and due to come into force in 2020. APRA recently released a discussion paper detailing proposed amendments to the capital framework to better align overall capital levels with the underlying risk of banks' lending and other activities. This follows the finalisation of reforms to the international Basel III capital framework. With the design of key post-crisis reforms now largely completed, global bodies are increasingly focusing on monitoring the implementation, and evaluating the effectiveness and impact, of the financial reforms.

Conduct in the banking sector is the focus of several inquiries. Notably, the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry has commenced, the Productivity Commission investigation of competition in the financial system has issued a draft report, and the interim report by the Australian Competition and Consumer Commission on mortgage pricing has been published. Over time, these examinations should enhance accountability and strengthen risk culture in the financial sector. The International Monetary Fund has started work on its five-yearly Financial Sector Assessment Program review of Australia, which will focus on current financial vulnerabilities and the Australian framework for systemic risk oversight.

An important development in recent months was the launching of the New Payments Platform (NPP), which enables very fast payments on a 24/7 basis using a recipient's email address, phone number or ABN. The NPP will increase the efficiency of the payments system and may support productivity more broadly. It also changes the nature of the risks in the Australian payments system, reducing the delay in receiving funds while increasing the importance of real-time monitoring to prevent financial fraud. Other financial market infrastructures have continued to function effectively.