

Overview

Volatility in global financial markets has increased somewhat since the previous *Review*, following a lengthy period of very low volatility and compressed risk premia. Divergent economic and monetary policy outlooks in the major advanced economies have contributed to some sharp adjustments in currency markets as the US dollar has appreciated. The fall in oil prices has added to downward pressure on oil exporters' currencies and widened yield spreads on bonds issued by oil producers, although it is positive for global growth overall. To date, financial systems have been resilient to this increased volatility.

Low interest rates in the advanced economies continue to encourage financial risk-taking. Although this is supportive of economic growth, such activity can contribute to a build-up of financial system vulnerabilities. A broad reassessment of risks could lead to a sharp adjustment in asset prices, particularly if investors have not fully adjusted to an environment of lower market liquidity. Potential triggers for a reassessment include actual and expected monetary policy actions as well as a range of geopolitical risks.

Risks surrounding euro area banks and sovereigns remain. There have been some broadly supportive developments over the past six months, including the European Central Bank's decision to expand its asset purchase program and the conclusion of its comprehensive assessment of the euro area banking system. However, many banks are still dealing with high levels of impaired assets, a task made more difficult by the slow pace of the economic recovery. Low nominal income growth continues to weigh on

the process of balance sheet repair. Vulnerabilities are most acute for euro area economies where sovereigns are more indebted, particularly Greece where negotiations between the new government and its creditors are still proceeding.

In emerging Asia, including China, the slower growth outlook has focused attention on the ongoing build-up in indebtedness in a number of countries, as well as developments in asset prices. Higher debt levels have potentially made Asian financial systems more sensitive to adverse shocks.

Meanwhile, the Australian financial system continues to perform strongly. Banks' asset performance improved further over the second half of 2014, while their profitability remained robust. The recent increase in volatility in global funding markets has had only a minor effect on banks' wholesale funding costs, and their direct exposures to the countries in stress are low. The banking system has continued to accumulate equity capital organically and increase total capital through net issuance of other capital instruments. Looking forward, a number of domestic and international policy initiatives, if implemented as recommended or proposed, would require banks to increase their capital positions further over time.

Competition among lenders remains vigorous in a number of domestic markets and lending margins have fallen. Property-related lending has been a particular focus of the competition in the corporate lending market. Although the Australian banking system's exposure to the commercial property sector declined following the global financial crisis, and the recent lending has not increased its share

of banks' domestic assets, risks in this area appear to be building. Investor demand for both new and existing commercial property developments has been strong, despite weakening leasing conditions in a number of market segments. Particular caution around collateral valuations is warranted in the current environment of declining property yields. Lenders should also be mindful of the collective effects of strong lending activity within particular market segments, even if individual borrowers appear to be of low risk.

Household sector risks continue to revolve largely around the housing and mortgage markets. At this stage, competitive pressures have not induced a material easing in non-price housing lending standards. The composition of new mortgage finance remains skewed to investors, however, particularly in the largest cities. Ongoing strong speculative demand would tend to amplify the run-up in housing prices and increase the risk that prices in at least some regions might fall significantly later on. In the first instance, the consequences of such a downturn in prices are more likely to be macroeconomic in nature because the effects on household wealth and spending would be spread more broadly than just on the recent property purchasers. However, the further housing prices fall in that scenario, the greater the chance that lenders would incur losses on their housing loans. At the margin, the recent decline in mortgage interest rates can be expected to boost demand for housing further, though it will also make it easier for existing borrowers to service their debts. Indicators of household stress are currently at low levels, but could start to increase if labour market conditions weaken further than currently envisaged.

In this environment of low interest rates and strong demand, it is important that lending standards do not decline, and the measures announced by the Australian Prudential Regulation Authority and the Australian Securities and Investments Commission in December are designed with that intent. While it is too early to see the effects of these measures in

overall housing lending activity, the authorities will be monitoring an array of information in the period ahead to help ensure that the current risk profile in the mortgage market does not deteriorate.

Outside of the property markets, risks in the non-financial business sector appear relatively low. Measures of distress such as non-performing loans and business failures have been declining and gearing ratios remain lower than those prevailing before the financial crisis. Some resources and mining services firms are facing more difficult trading conditions now that the mining investment boom is winding down and some commodity prices have fallen sharply. However, firms in these industries typically carry less debt than similarly sized firms in other industries, and much of their borrowing is from outside the domestic banking system.

International financial reform work has continued across the four core areas emphasised during Australia's G20 presidency in 2014. Many of these post-crisis reforms have now been agreed and are in the process of being implemented, although some design work remains to be completed, including on the proposal for total loss-absorbing capacity for global systemically important banks. Progress in implementing some reforms affecting derivatives markets has been slow and uneven. This is in part because of difficulties posed by regulation in some jurisdictions that has cross-border effects, or that does not allow their national authorities to defer to counterparts in other countries with oversight of activity within their own borders.

Domestically, the *Financial System Inquiry Final Report* was published in December. In line with the Interim Report, the Final Report does not recommend substantial changes to the regulatory architecture in Australia, but makes several recommendations to strengthen the resilience of the banking sector. The Report also calls for existing processes for strengthening crisis management powers to be completed; these had been put on hold pending the outcome of the Inquiry. ✎