

Overview

Global economic and financial conditions are generally positive

Growth has been above trend rates in the major advanced economies and in most of Australia's major trading partners. Central banks in the United States and some other advanced economies have begun to remove the exceptional monetary policy stimulus. But monetary policy has remained very expansionary in the euro area and Japan. Overall, global financial conditions remain highly accommodative. The tightening in the United States and divergent monetary policies have not disrupted financial markets as central banks have been careful to clearly communicate their expected paths for policy. Overall, positive economic and stable financial market conditions have supported financial stability. However, the extended period of low interest rates has seen some financial stability risks emerge. Notably compensation for risk is very low with asset prices in a range of markets at high levels, underpinned by low long-term interest rates. Household, corporate and sovereign debt has also risen to high levels in some jurisdictions. For emerging market economies – especially those with structural or cyclical vulnerabilities – there are concerns about the implications of a tightening in financial conditions in the advanced economies.

The Australian economy is improving while the housing market has slowed

In Australia, economic growth has been strong, with unemployment falling. Wages growth has been low, but strong employment growth has helped to support household incomes. Similarly, businesses are earning solid profits. Given most businesses have low gearing, few have difficulty in servicing their debt.

Conditions in the housing market have eased, reflecting shifts in both supply and demand. Sentiment towards the housing market has become more cautious and this has been reflected in a slowing in demand for housing finance, particularly from investors. This has been reinforced by stricter lending conditions as a result of actions by regulators over the past few years, notably on investor, interest-only and high loan-to-valuation loans. The prudential measures were introduced because of concerns about the growth of riskier types of housing lending, particularly given that the level of household debt was already high. The banks have also applied their own lending standards more diligently. Most borrowers do not take out the maximum loan possible and so the vast majority of prospective borrowers have not been affected by these changes. However, some existing borrowers may find they do not meet new lending standards and so have difficulty refinancing. Similarly, while most borrowers with loans transitioning from interest-only to principal and interest payments are well placed

to meet the higher payments, a small share could struggle. There has been only a small uptick in non-performing housing loans, primarily in Western Australia; overall, rates of non-performing loans remain very low. For non-residential commercial property, valuations continue to rise in the eastern states and yields have fallen further, in line with high global asset prices underpinned by low long-term interest rates.

There are some vulnerabilities for Australian financial stability

External exposure

Australia would be sensitive to a sharp contraction in global growth or dislocation in global financial markets because of the importance of trade and capital inflows. A worsening in external conditions could see a downturn in the domestic economy, reduced availability and higher cost of offshore funding and falls in asset prices, with a resulting deterioration in the performance of borrowers and lenders. In the current environment, a range of possible triggers could precipitate a global economic downturn. An escalation of trade protection could see a sharp fall in trade, business confidence and investment. A fall in economic growth in China, possibly stemming from the high level of debt and the complex and obscure linkages in the financial system, would spread to many economies, including those in Asia with strong economic links to Australia. Global financial market volatility and risk premia could rise for a range of reasons. Contagion among emerging market economies could spread from Argentina and Turkey, or banking and sovereign debt problems in Europe could escalate from Italy. And an increase in risk aversion could see a jump in premia in long-term interest rates undermining high asset valuations.

Household debt

The level of household debt in Australia is high relative to its history and to other countries. Directly, this does not appear to be a large risk to the financial system. The majority of this debt is well secured, with only a small portion having a high loan-to-valuation ratio. Further, most of the debt is owed by households that appear well placed to repay the debt. Rather, the risks of high household debt appear to be to the economy. Highly indebted households could cut back their consumption if their financial position were to be less secure. Given high household debt, these effects could potentially be substantial for the aggregate economy, indirectly affecting the financial system.

The housing slowdown and credit supply

The housing market has slowed in part reflecting policy measures over the past few years. After the substantial rise in housing debt and prices over the past decade, this is a positive development for financial stability. But if the housing market were to contract sharply, this would result in some borrowers having negative equity. It is possible, although not likely, that an excessive tightening in lending standards could exacerbate the current housing slowdown. Most of the tightening in lending standards prompted by regulators is already in place, however, banks are further adjusting their own lending standards. A tightening in banks' risk appetite could particularly affect housing developers and so construction.

Bank culture and operational risk

In the past year inquiries into the Australian banks have exposed deficiencies in operational risk management stemming from poor culture. The response of financial institutions will, over time, contribute to a more resilient financial

system. But the evidence presented highlights the deficiencies that can arise with insufficient control of operational risk. To date, the financial implications for banks have been small, but the consequences of reputational damage could impair banks' profitability and resilience. Cyber risk is an operational risk that warrants particular attention. Australian financial entities have not experienced significant losses or disruption from cyber attacks, but they are targets. The likelihood of a cyber attack having systemic consequences seems small, but the implications could be severe.

Financial system resilience has improved

The resilience of Australian banks has increased over the past decade. Banks' capital ratios are now around their 'unquestionably strong' prudential benchmarks. They are also around 50 per cent higher than they were a decade earlier and well within the range that has historically helped to withstand financial crises. Banks have also substantially strengthened their liquidity management in recent years, switching to more stable funding and increasing holdings of liquid assets. The strengthening of capital positions and liquidity management has reduced banks' return on equity (ROE) relative to its historical average. However, their ROE appears to have stabilised at a level that is still high by international standards (around 12 per cent, compared with 8 per cent for large US banks).

The tightening in housing lending standards in recent years has improved the quality of the household sector's balance sheet (see the special chapter, 'Assessing the Effects of Housing Lending Policy Measures'). Some borrowers who would have been more likely to experience difficulty repaying their debt are now constrained

to borrow more manageable amounts. In response, lending by non-prudentially regulated lenders has picked up, but they must still comply with responsible lending laws and are too small to fully offset the tightening from other lenders. Tighter lending standards mean there should be fewer households that will struggle to service their debt if they experience falls in income or other adverse conditions. This has alleviated some of the risks from the continued rise in household indebtedness. ✖

