# Malcolm Edey: The risk environment and the property sector

Speech by Mr Malcolm Edey, Assistant Governor (Financial System) of the Reserve Bank of Australia, at the Australian Property Institute's Queensland Property Conference, Gold Coast, 6 November 2015.

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Thanks for the opportunity to speak to you today.

This being a conference of the property industry, I expect you will want to hear me say something about the Australian property market. I will come to that a bit later in the speech. First, though, I want to provide some context for that by talking about the financial and economic environment more broadly. In doing so, I will be making some longer run observations as well as drawing on the analysis recently published by the Reserve Bank in our half-yearly *Financial Stability Review*.

### The post crisis environment

I want to begin by noting that the process of recovery from the global financial crisis (GFC) has been underway for some years. The epicentre of the crisis is usually dated to the collapse of Lehman Brothers in September 2008, and the general recovery that we have had since then began about six months later. On that basis, we have been in a period of aggregate global recovery now for about 6½ years.

In broad outline, this has been a period marked by:

- a return to approximately trend growth in world GDP, though with some variations around that; (Growth is currently a bit less than trend.)
- widespread, though somewhat variable, progress in balance sheet repair in banking institutions; and
- improved conditions in financial markets.

These are all positive developments, and they represent a substantial cumulative improvement since the height of the crisis.

That said, there are a number of qualifications that should be made to the summary picture I have just given:

- Growth around the world during this period has been uneven geographically. China and other emerging market economies have led the recovery for much of the period, the US has achieved fairly steady growth, while Europe tended to lag. (More recently Asian growth has softened while Europe has picked up somewhat.)
- Significant labour market slack remains in some areas of the global economy, especially in parts of Europe.
- And the recovery has been marked by periodic bouts of nervousness in financial markets.

One general indicator that things are still some way short of normal is the level of global interest rates, which are still at exceptionally low levels to support growth.

An obvious question that arises from all of this is, why has the recovery from the deep recession of 2008 and 2009 been as protracted as it has? I suggest that there are two important factors at work here.

The first factor is that the GFC period involved more than one crisis. It began in the US mortgage market in 2007 and spread through various channels of contagion to banks and financial institutions in other parts of the world, especially the euro area and the UK. That was the initial crisis, triggered by poor asset quality and excessive leverage.

But even as the US was recovering from that, a second crisis was developing in Europe. This was a crisis of confidence in the sustainability of the euro as a single currency area. At different times a number of the weaker economies in the area came under scrutiny as to whether they would be able to meet their obligations, and concerns were particularly focused on Greece in key periods. These episodes led to strains in financial markets and increases in risk pricing, and they weighed heavily on confidence and on the pace of recovery. With the euro area accounting for around one fifth of the global economy, this in turn acted as a significant drag on global growth.

The second factor is that, other things equal, recoveries from financial crises typically take longer than those from other types of business cycle events. It takes time to repair balance sheets, to reduce excessive leverage and to unwind the asset market imbalances that might be left behind by a crisis; and it takes time to reverse the damage to trust and confidence. One important recent study[1] found that the average duration of impact from financial crises across a range of countries over the past two centuries has been around four to five years. Since this current episode has been more severe than most, it is not surprising that its after-effects have lasted even longer.

An exacerbating factor, too, has been the international dimension. When a financial or a banking crisis occurs in a single economy, or in a smallish group of countries, exchange rate depreciation is often part of the market response and part of the recovery mechanism. But there is obviously much less scope for that mechanism to work when a crisis affects large parts of the global economy simultaneously.

Taken together I think these factors go a long way towards explaining the rather drawn-out nature of the global recovery to date – even though, as I said, conditions now are much better than they were a few years ago.

Policymakers around the world have been responding to this situation on a number of fronts. Interest rates were reduced to near zero (or even slightly below zero) in many advanced economies to support recovery and assist in balance sheet repair, and they still remain at those levels. In Europe, significant institutional reforms are being made to strengthen the stability of the euro area; these are aimed at getting banking and crisis-management arrangements across the area to function in a more unified way that makes them more robust to shocks in the future. And globally, there is an extensive program of reform underway, for example in banking and securities regulation, to build resilience in our financial systems. Australia has been very much a part of that process.

A related development in this period is that there has been a renewed interest in more proactive approaches to the management of systemic risk. Partly this reflected the lesson from the GFC itself that financial crises are costly, and hence that there is a strong need for better risk management. In keeping with that, institutional arrangements have been strengthened in some jurisdictions to support more proactive risk management by supervisors, where that was found to be lacking. A related point is that, in a low interest rate environment, supervisors have seen a need to be particularly vigilant against a build-up of risk in interest sensitive sectors. A number of them have been taking measures in recent times to respond to developing risks, often focused on property lending. I will have more to say about that later.

To summarise (and oversimplify) this picture somewhat, the after-effects of the GFC on the global economy have included:

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[1] Reinhart CM and K Rogoff (2009), *This Time is Different: Eight Centuries of Financial Folly*, Princeton University Press, Princeton.

- an extended period of low interest rates
- "search for yield" behaviour by investors in some interest-sensitive sectors, and
- a strengthened focus on risk management by prudential supervisors.

**Recent developments**

With all of that as background, I want to turn now to our assessment of the evolving risk environment over the past six months, and here I draw on some key messages from our recent *Review*.

It is useful to take that subject in three parts:

- the global risk environment;
- possible implications of that environment for Australia; and
- domestically generated sources of risk.

**The global risk environment**

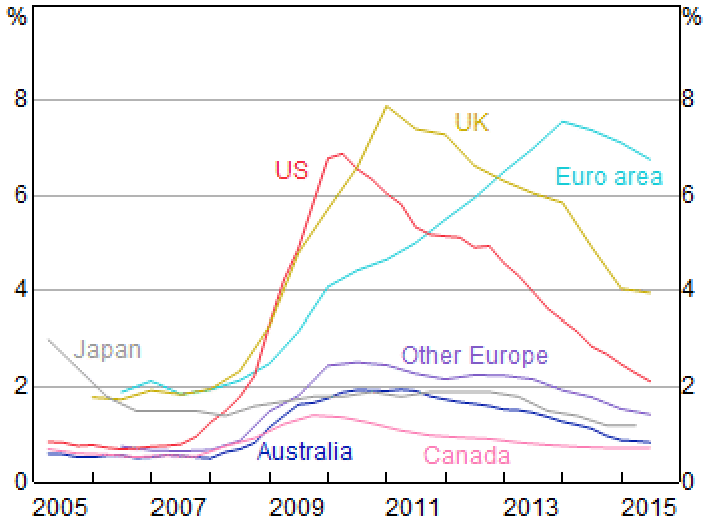
As I have already mentioned, much of the attention from a financial stability point of view over recent years has been on Europe. There has been a particular focus on Greece, and on potential spillovers from Greece to other parts of the euro area. Those concerns came to a head around the middle of this year. For the time being at least, they seem to have been allayed by the new bailout package agreed at that time. Unlike the earlier phase of the Greek crisis in 2011 and 2012, market spillovers from this latest bout of uncertainty have been quite limited; for example, risk spreads on securities across other parts of Europe remained relatively low. This seems at least partly to reflect a greater degree of confidence in Europe-wide institutions. The European authorities have taken a number of actions to reduce channels of contagion, including increased support from the ECB and ongoing progress in unifying the system of banking regulation.

More generally in Europe, the condition of the financial sector has been improving over the recent period in a number of respects. Non-performing loans of European banks are still high, but they have been falling for more than a year (Graph 1). Bank profitability has picked up and banks are now better capitalised. Stronger balance sheets have enabled banks in the euro area to make some gradual increases in their lending to businesses and households. Overall, while financial conditions in Europe are still some way from a return to normal, they are significantly improved from their position of a few years ago.

Graph 1

**Large Banks' Non-performing Loans***

Share of loans




* Definitions of 'non-performing loans' differ across jurisdictions; number of banks: Australia (4), Canada (6), euro area (41), Japan (5), other Europe (10), United Kingdom (4) and United States (18)

Sources: APRA; Banks' Annual and Interim Reports; Bloomberg; FSA; RBA; SNL Financial

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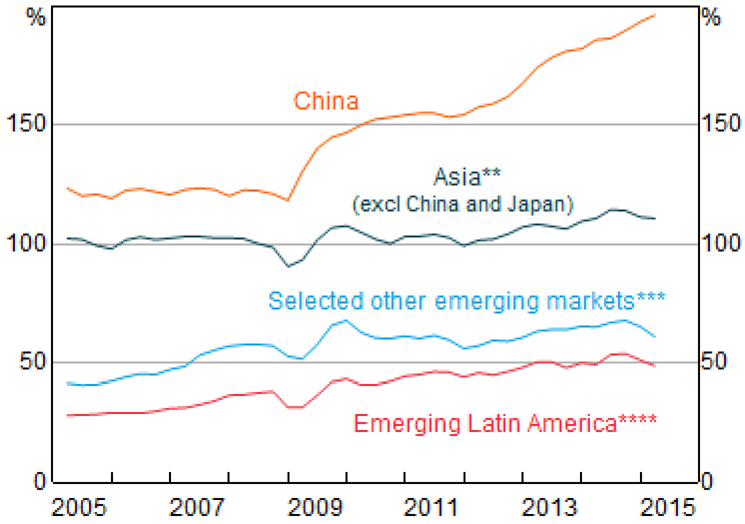
While financial risks in Europe seem to have lessened recently, attention has shifted to China and other emerging market economies. China has been an important engine of growth in the post-crisis period. Nonetheless, our latest *Review* notes that financial stability risks in China have been building. The Chinese economic expansion over recent years has been associated with increasing debt, strong asset price growth and apparent overinvestment in some sectors (Graph 2). If the nominal growth rate were to fall further from its high recent rates, any past excesses might be exposed – leverage is always harder to manage in a slower growth environment. These risks of course are hard to assess. The Chinese authorities have many levers to support growth and financial stability, given the ongoing large role of the state in the economy, the heavily regulated financial system and the presence of capital account controls. The measured central government fiscal position is also very strong, though the overall public sector position is less so given the build-up in debt among local governments and state-owned enterprises.

Graph 2

**Total Debt of the Private Non-financial Sector***

Selected economies, per cent to GDP at market exchange rates




* Loans and other debt funding provided by domestic and non-resident sources

** Hong Kong, India, Indonesia, Malaysia, Philippines, Singapore,
South Korea, Taiwan and Thailand

*** Czech Republic, Hungary, Poland, Russia, Saudi Arabia, South Africa
and Turkey

**** Argentina, Brazil and Mexico

Sources: BIS; CEIC Data; RBA; Thomson Reuters

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Outside China, country-specific risks seem to have increased in a number of other emerging market economies – for example Brazil, Russia and Turkey. Among the various factors contributing to that in recent times have been falling commodity prices, political instability and excessive corporate leverage. Equity prices and exchange rates in these economies have fallen quite sharply.

Taken together these developments have contributed to a pick-up in volatility in global financial markets over the past six months, after a lengthy period when volatility and risk pricing were unusually low. Even so, risk pricing in most markets remains well below the crisis-related peaks of a few years ago.

## Implications of the global risk environment for Australia

At this point it is useful to ask how these international sources of risk might affect the Australian financial system.

Direct exposures of Australian banking institutions to the risk factors I have been describing are quite limited (Table 1). Exposures to the euro area have been scaled back in the wake of the crisis and now represent only around 1 per cent of Australian banks' consolidated global assets. Although exposures to the Asian region have been growing quite rapidly over recent years, they are still a relatively small share of consolidated assets – around 5 per cent. Many of these exposures are shorter-term and trade-related, factors which should lessen credit and funding risks. That said, operational and legal risks could be relatively high, particularly given the rapid expansion of these activities in recent times.

Table 1

**Australian-owned Banks' International Exposures**
Ultimate risk basis, June 2015

| | Value | Share of international exposures | Share of global consolidated assets |
|---|---|---|---|
| | $ billion | Per cent | Per cent |
| New Zealand | 330 | 35 | 9 |
| Asia[(a)] | 183 | 19 | 5 |
| *– China* | *45* | *5* | *1* |
| United Kingdom | 176 | 19 | 5 |
| United States | 140 | 15 | 4 |
| Europe | 58 | 6 | 1 |
| *– Greece* | *0* | *0* | *0* |
| Other | 59 | 6 | 2 |
| **Total** | **945** | **100** | **24** |

(a) Asia includes offshore centres Hong Kong and Singapore.

Sources: APRA; RBA.

As a more general observation, Australian banks have increased their resilience over recent years in a number of respects, responding both to market expectations and to regulatory and supervisory actions. Notably they have raised their capital ratios and shifted their funding structures to make them more resilient to financial market disruptions. Of course, none of this guarantees that Australian banks will be immune to international shocks in the future. But it suggests that the main effects from the risks I've been describing are likely to be indirect, working through the impact of factors like commodity prices, trade flows, and confidence, on the broader economy.

## Domestically generated sources of risk

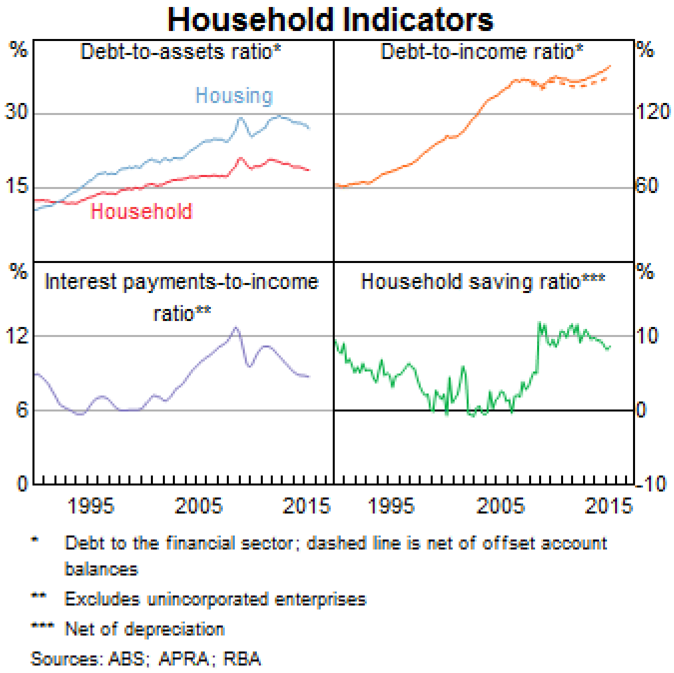
That brings me to the third part of our risk assessment, namely domestically generated sources of risk. Here our analysis has for some time focused on the buoyancy in parts of the property market and the leverage associated with that. Much of the focus has been on residential property, and I will start with that before turning to the commercial sector, where risks have also been growing.

While the housing market has not been universally strong around the country, we have been seeing significant strength in the Sydney and Melbourne markets in recent times, with investors playing a large role. To summarise a few key facts:

- Housing prices in Sydney have increased by 31 per cent over the past two years, and reached an annual rate of increase of almost 20 per cent earlier this year.
- Melbourne prices were up by 16 per cent over the year to September this year.
- The value of loan approvals to investors in New South Wales approximately doubled over the two years to mid-2015.

As a result of these developments, the household debt ratio has started to edge up again from a level that was already high, at around 1½ times annual income (Graph 3).

Graph 3

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It is against this background that the Reserve Bank has highlighted the need for prudence, and has supported APRA and ASIC in the measures that they have taken to strengthen lending standards.

As a general proposition, mortgage lending standards in the post-crisis period have been relatively tight, at least more so than before the crisis. Low-doc loans are rare, genuine savings are required to fund at least part of the deposit, and the application of interest rate buffers in serviceability assessments has become common. Nonetheless, investigations by APRA and ASIC have shown that there was some slipping in lending standards and that they were inadequate in some important respects to the current risk environment. Specifically, APRA found that, in some instances, lenders' serviceability assessments were based on over-optimistic judgments about the reliability of borrowers' incomes, or inadequate estimates of borrowers' living expenses, or that they failed to take into account the possible effect of future interest rate movements on a borrower's existing commitments. ASIC's review of interest-only lending practices made similar findings, and also noted instances where the lender did not make reasonable inquiries as to whether the loan product was suitable to the borrowers' circumstances.

Further to those findings, as a result of the additional scrutiny over the past year and substantial data revisions made by the banks, we now know that the level of investor activity in the housing market was in fact higher than previously thought.

As you know, APRA announced a number of supervisory measures in December last year to strengthen mortgage lending standards. These measures included expectations that:

- banks should not be increasing their share of higher risk lending
- growth in investor lending should not be materially above 10 per cent

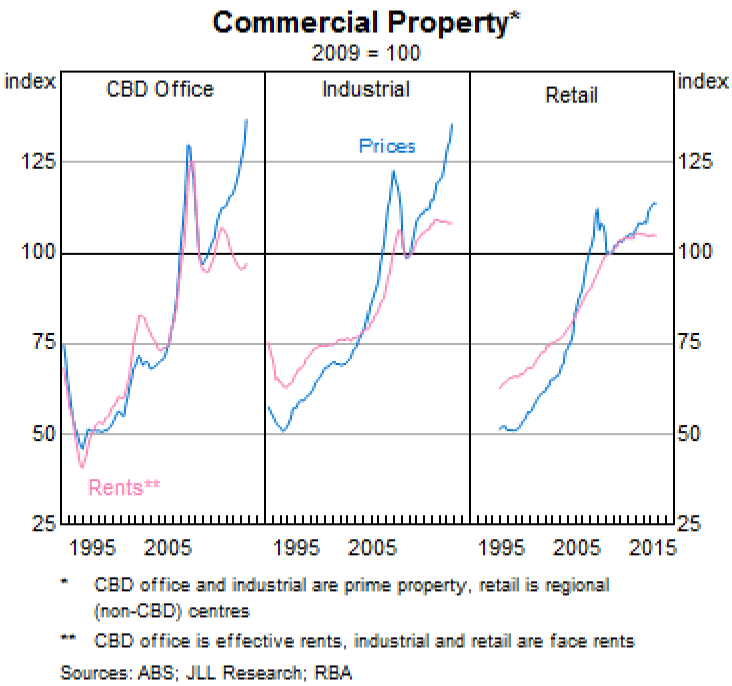
- appropriate interest rate floors and buffers should be applied in serviceability assessments.

It will take time for the full impact of these measures, and of the more recently announced increases in bank lending rates, to become apparent. Nonetheless, the indications to date are that the supervisory measures are having a beneficial effect on lending standards and are assisting in restraining new investor finance. There is also some tentative evidence that sentiment may now be turning in the housing markets in the two largest cities. But it is much too early to be definitive about that. What we can say is that the risks in that sector are now being more prudently managed than they were a year or so ago.

The second main area of risk focus domestically is in commercial property. Historically this has been a common source of financial instability both here and abroad. During the height of the GFC, Australian banks remained in comparatively good shape but they did suffer a noticeable deterioration in asset performance, with the aggregate non-performance rate rising to just under 2 per cent of loans. A significant part of that deterioration was in commercial property lending; impaired commercial property exposures accounted for around 30 per cent of Australian banks' non-performing domestic assets at that time.

After the post-crisis downturn, the commercial property sector is again experiencing strong investor demand, and bank lending to the sector is increasing. However there are a number of signs of increasing risk. Trends in commercial property prices and rents have been diverging over the past few years, with prices continuing to rise while rents have been flat to down (Graph 4). As a result, yields have declined. At the same time, vacancy rates have been increasing.

Graph 4

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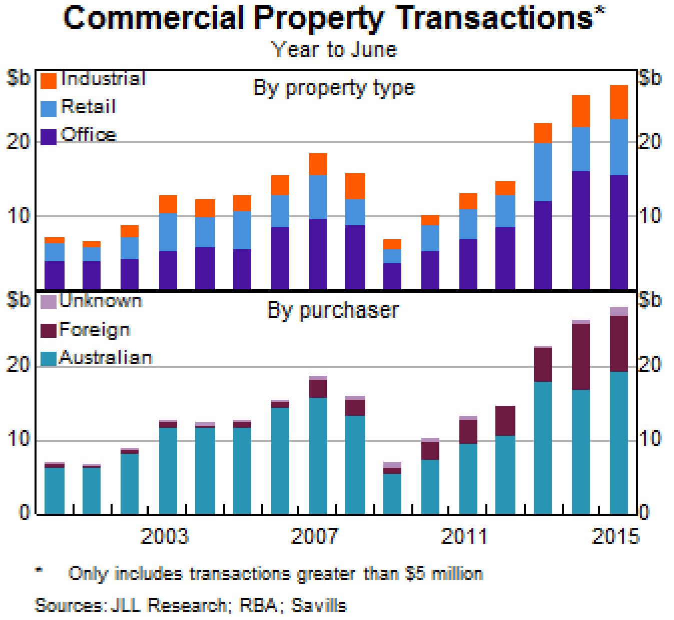
As in the housing market, conditions have not been uniform across the country, and they have been noticeably firmer in Sydney and Melbourne than in other centres. But in aggregate, the major categories of commercial property have all seen downward pressure on yields over recent years. Strong demand from foreign buyers has contributed to this, reflecting the global environment of low interest rates and "search for yield" (Graph 5). The risks appear manageable at this stage, but they underscore the need for sound lending practices and for appropriate prudence by investors.

Graph 5

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**Concluding comments**

I want to conclude with a few comments about the financial stability role of the Reserve Bank[2].

The Bank has a longstanding mandate for financial stability, affirmed for example as part of the Wallis reforms in 1998. In the post-Wallis world, this has not been primarily a regulatory function. The Bank does have regulatory powers in some areas relating to financial stability, notably in its oversight of payments systems and financial market infrastructures. But the financial stability function goes well beyond that to the Reserve Bank's wider role in the financial system. It includes the Bank's role as liquidity manager for the system and as the provider and operator of core payments infrastructure. It also includes coordination with other regulators. At a formal level, this is done through the Bank's role in chairing the Council of Financial Regulators, but there are numerous less formal channels for coordination and for sharing information and analysis. These arrangements were reviewed and supported most recently in the Murray Inquiry.

One important component of our financial stability work is the provision of timely risk analysis, to help inform the policy debate and also to help inform the decisions of lenders and investors. I have given a summary of our most recent analysis today, and I hope you will find that helpful in informing your own investment decisions.

With that, I thank you for your attention, and hope you have a successful conference.

[2] For a fuller discussion of this topic, see my earlier speech "The Financial Stability Role of Central Banks" May 2013.