# Overview

Financial stability risks have increased over recent months. Global financial conditions have continued to tighten as persistently high inflation has prompted an unusually rapid and synchronised increase in policy rates in advanced economies. Growth forecasts for the global economy have been revised down sharply and geopolitical tensions have severely disrupted energy markets. A turn in the global credit cycle is likely at hand, though from a starting point where loan arrears are very low and large banks are liquid and well capitalised.

In response to the sharp increase in interest rates and an increasingly uncertain outlook for the global economy, financial asset prices have declined significantly and volatility has risen over recent months. Trading conditions in energy markets, particularly for European gas, have remained fragile following Russia's invasion of Ukraine. Heightened volatility in global financial markets has seen margin calls and liquidity shortfalls transmit through parts of the financial system, including non-bank financial institutions where regulators have less visibility over the use of leverage. Bank funding markets have been less affected by the recent pick-up in financial market volatility.

Beyond financial markets, the impact of higher interest rates has been most evident in the slowing or reversing of housing price growth in many economies after a large run-up in prices over recent years. Credit remains readily available to households and firms, but growth in housing credit is slowing alongside higher interest rates.

Different regions are experiencing different financial stability challenges. A sharply deteriorating outlook for growth and inflation in Europe has reignited concerns over sovereign credit risk and related banking sector vulnerabilities in parts of the euro area. The tightening in global financial conditions, appreciation in the US dollar and high energy prices have contributed to difficult funding conditions for some emerging market economies. In China, policymakers have responded to deteriorating conditions in the property sector and the impact of rolling lockdowns by stepping up policy support; however, the policy challenges are becoming more complex and the medium-term outlook more uncertain as a result.

In Australia, households, firms and banks are generally entering this more challenging environment in a strong financial position, though pressures on household budgets and business cash flows are rising and housing prices are declining. Many Australian households and businesses built up substantial savings buffers during the pandemic, and strong growth in incomes has supported the recovery in household consumption and contributed to low levels of loan arrears.

However, the resilience across private sector balance sheets in Australia is unevenly distributed. Some households are already feeling the strain from higher interest rates and inflation, and this is likely to continue for some time. A small number of borrowers have both high debt relative to their income and low saving and equity buffers; these households are particularly vulnerable to shocks. Most borrowers have

accumulated a large amount of equity in their homes, reflecting the large run-up in housing prices over recent years and the small share of high loan-to-value lending. This reduces financial stability risks in instances where borrowers encounter debt-servicing difficulties. Business insolvencies have picked up toward more normal, pre-pandemic levels, including in sectors where cost pressures are acute.

Banks in Australia remain liquid and very well capitalised. Large capital buffers mean that banks are well positioned in the event that non-performing loans pick up from their very low levels in the period ahead. Non-bank lending has been very strong and it is important that lending standards remain prudent. Banks and non-banks continue to have ready access to wholesale funding.

## Key risks to financial systems

### 1. Financial conditions could tighten further, leading to disorderly declines in asset prices and disruptions to financial system functioning

Financial stability risks would be magnified by a further substantial tightening in global financial conditions. One potential catalyst is that inflation stays high for longer than expected, requiring a larger and more persistent tightening in monetary policy than is currently reflected in financial market pricing. This would exacerbate the risk of a global recession and likely result in a further widening in risk premiums. Large and disorderly declines in financial asset and property prices as a result of higher interest rates and increased risk aversion could disrupt key funding markets and strain the balance sheets of some borrowers and lending institutions. A sharp drop in the demand for and supply of credit would worsen the ensuing downturn and increase the risks to financial stability.

### 2. As debt-servicing challenges increase, a turn in the credit cycle is likely; a sharp increase in unemployment would magnify these challenges

In aggregate, households and businesses in most jurisdictions have entered the interest rate tightening cycle with strong balance sheets and banks are well capitalised. This is also the case in Australia. However, the combination of higher interest rates and inflation will increase pressure on household budgets and business profitability over the period ahead. This is likely to lead to a turn in the credit cycle, including for lenders in Australia, following a period of very low loan arrears. Debt-servicing challenges will become more difficult still if household incomes are affected by worse-than-expected labour market outcomes.

A small group of borrowers in Australia are particularly vulnerable to repayment difficulties due to rising interest rates and cost-of-living pressures. Many of these households have low liquidity buffers, low incomes and high debt relative to their income. A large decline in housing prices that results in negative equity for households, alongside further shocks to disposable income, would increase the risk that some borrowers default on their loan commitments.

While corporate indebtedness in Australia remains low, many businesses face rising cost pressures, higher interest expenses and slowing revenue growth. Forbearance assisted many firms through the pandemic but is now winding down and insolvencies have started to pick up more recently. There is considerable variation across industries in businesses' capacity to service debt; those still dealing with pandemic-related disruptions or with energy-intensive cost bases, as well as those with low cash buffers and high levels of debt, are most vulnerable.

Bank balance sheets in Australia are expected to remain resilient to an increase in loan arrears under most plausible scenarios. However, in

some economies, a turn in the credit cycle could test the resilience of some lenders (including smaller banks and non-banks) – particularly those with relatively low capital buffers and high leverage, and/or whose lending standards have slipped in recent years.

### 3. Threats from outside the financial system – including cyber-attacks, geopolitical tensions and climate change – continue to pose risks to financial stability

Cyber-attacks could give rise to systemic risks, a point underscored by the recent attack on Optus. It is probable that a significant financial institution or market infrastructure will be subjected to a successful attack at some point given the increasing sophistication and frequency of cyber-attacks. This could create considerable difficulties for the institution or market concerned and undermine confidence in the broader financial system. The growing risk of cyber-attacks calls for stepped up investment in cyber defence capabilities and increased focus on contingency and recovery plans.

Worsening geopolitical tensions present a growing risk to macroeconomic and financial stability. A deteriorating geopolitical environment has the potential to lead to widespread disruptions to global trade and capital flows. It could also magnify the risk of cyber-attacks on key institutions and infrastructure.

Finally, climate change and extreme weather events have the potential to affect economies and societies on a global scale, and thereby present a systemic challenge for private institutions and policymakers. Both physical and transition risks could result in large losses for financial institutions that are yet to put in place adequate risk controls and resilience strategies.