Overview

Improved economic conditions have reduced financial system vulnerabilities in advanced economies over the past six months

Globally, financial systems have remained resilient – despite the ongoing effects of the COVID-19 pandemic – and are supporting economic recoveries. Aided by expansionary fiscal and monetary policies, output has rebounded in most economies, particularly those with a more progressed vaccination rollout. Improved economic conditions have seen increased earnings for businesses and households, strengthening balance sheets and debt repayment capacities. As a result, banks' loan losses have been much lower than was expected early in the pandemic. Many banks have therefore been able to reduce the provisions they were holding against future loan losses. This has boosted banks' profits and improved their capital positions, which in turn has allowed regulators to remove restrictions on capital distributions.

However, there have been temporary setbacks given the spread of the highly-infectious Delta variant of COVID-19. These setbacks have been most severe in emerging market economies (EMEs) as the rollout of vaccines is generally progressing more slowly than in advanced economies. Despite some EMEs raising interest rates to counter rising inflation, financial conditions in most EMEs have remained expansionary for now.

In Australia, the economy was recovering well over the first half of the year, further strengthening household and business balance sheets. Economic output and employment had exceeded pre-pandemic levels; although, due to some reduced spending opportunities and a degree of caution related to the pandemic, high household saving was still contributing to households building their liquidity buffers. Given the economic rebound, Australian banks had started to write back provisions for loan losses, and their continued profitability had increased their resilience. Indeed, with banks' capital ratios increasing to be even further above regulatory requirements than before the pandemic, they had been allowed, and had started, to increase their capital distributions.

However, the spread of the Delta variant and ensuing extended lockdowns in New South Wales, Victoria and the ACT has resulted in output and employment falling in the September quarter. For the most affected households there is fiscal support, similar to last year, which will limit the increase in financial stress. Banks are offering targeted loan repayment deferrals to households and small and medium-sized businesses, supported by regulatory actions; however, the number of deferred loans is a fraction of those taken up in 2020. The businesses and households most at risk of experiencing financial stress continue to be those in the most impacted industries (such as tourism, retail and hospitality) and those in the areas with the most stringent extended lockdowns.

The major financial system risks in Australia – and internationally – are dominated by the effects of the pandemic

The risks to financial stability from borrower payment difficulties have generally eased but remain

Financial stress persists for some borrowers, particularly those whose incomes have not recovered to pre-pandemic levels and as a result struggle to make loan repayments.

In Australia, the fall in output and hours worked in the September quarter demonstrated that the economic risk from the pandemic persists. However, the Australian financial system is highly resilient – with rapid progress in vaccinations, it is expected that output will rebound as the economy gradually reopens, reducing the risk to the financial system. But with most of the global population yet to be vaccinated and infections widespread, there is a risk that new highly infectious or even vaccine-resistant variants could emerge, making the outlook for the economy and the financial system highly uncertain.

Internationally, financial stability risks are particularly elevated in those EMEs where the recovery in output from large falls has been less complete and where low vaccination rates leave them susceptible to increased COVID-19 cases. Financial stability risks are particularly prevalent in countries with pre-existing macroeconomic and financial imbalances, such as Brazil, Turkey and South Africa. With interest rates projected to begin to rise in advanced economies as spare capacity declines, EMEs will face the prospect of capital outflows and exchange rate depreciations if they do not raise their domestic interest rates, but raising rates would further delay the recovery. Some have already tightened monetary policy in response to rising inflation, delaying the rebound in incomes.

In China, authorities remain focused on lowering elevated financial system vulnerabilities. Policy-makers face the challenge of addressing those vulnerabilities without triggering widespread stress and sharply lowering economic growth, while also focusing on their broader policy and social objectives. A prominent example of the trade-off between lowering vulnerabilities and economic growth is the liquidity crisis facing large real estate company Evergrande. Authorities may have to choose between imposing market discipline and intervening to avoid a disorderly resolution that could trigger stress in the financial sector or real estate industry that has been a significant contributor to growth in recent decades. In general, the numerous and simultaneous policy changes occurring at this time raises the probability of unintended consequences.

In a range of countries, the potential for trade, and even territorial, disputes remains a risk to incomes and confidence and ultimately to financial stability.

Expansionary financial conditions are underpinning rising asset prices and risk-taking

Low long-term sovereign interest rates, and optimism by financial market participants about business incomes, have continued to contribute to high and rising asset prices and increased risk-taking. Most major equity markets are well above, and credit spreads below, pre-pandemic levels. Significant rises in housing prices in many economies have also continued over the past six months. With interest rates expected to remain low to support the recovery and reflecting longer-run structural factors, investors have been taking on more risk to seek higher returns – for example, with greater purchases of debt issued by lower-rated companies.

While rises in asset prices have been underpinned by low interest rates and expected investment earnings, some asset prices appear

high given the pandemic still presents a risk to economic activity. Further, price falls could be widespread if interest rates were to increase sharply due to unexpected inflation or rising risk premiums. Sharp price falls could cause greatest harm to the financial system for assets where leverage is common, notably residential and commercial property. But even for other assets, sharp price falls could result in market dysfunction or illiquidity, as occurred in government debt markets in early 2020.

In Australia, there have been large increases in housing prices and an acceleration in borrowing. Higher prices have improved the financial resilience of existing indebted borrowers. However, there has been a build-up of systemic risks associated with high and rising household indebtedness. Vulnerabilities could build further if housing market strength gives way to exuberance, with expectations of further price rises leading borrowers to take on greater risk and banks potentially easing lending standards. To address this risk environment, in early October the Australian Prudential Regulation Authority (APRA) increased the serviceability assessment rate it expects lenders to use to assess prospective borrowers, thereby reducing maximum loan sizes. It is important that lending standards are maintained, and that the riskiness of system-wide lending does not increase.

Cyber-security and resilience is critical for financial stability

The number of cyber-attacks on financial institutions continues to trend higher. Over the past 18 months, this may have been accentuated by widespread remote working and use of electronic financial services due to the pandemic. Large financial institutions can devote significant resources to cyber defence, and so are generally regarded as having among the best cyber defences of any companies. However, given the very large number of attacks, it seems almost inevitable that at some point the defences of a significant financial institution will be breached. Whether such an attack could result in systemic financial instability will depend not only on the part of the financial institution or system impacted and potential network effects, but also the cyber resilience of that institution and financial system. In Australia and internationally, financial institutions and regulators are focusing on strengthening the resiliency of individual institutions and the financial system to a substantial cyber-attack.