Financial Stability Assessment

Global financial stability risks are elevated, reflecting challenging macroeconomic conditions.

The increase in inflation and interest rates since 2021 has put pressure on household and business finances in Australia and around the world. It has also exposed vulnerabilities in parts of the international banking system, in some non-bank financial institutions (NBFIs) and in segments of global financial markets. Periodic episodes of stress in some economies, including the banking stress in the United States and Switzerland in March 2023, have required intervention by policymakers to support financial stability.

Households and businesses in advanced economies have been largely resilient to date, despite a challenging set of economic conditions that includes high inflation, restrictive monetary policy settings and slowing growth. Low levels of loan arrears and high levels of capital and liquidity continue to support stability in the global banking system. However, global financial stability risks remain elevated.

Key global risks include:

- **The interaction of property sector stress in China with other long-running imbalances there that could spread to the rest of the Chinese economy and financial system and reverberate globally.** The property sector is a key part of the Chinese economy and could negatively interact with long-running macro-financial imbalances in China through interlinkages with local government financing, shadow banking activities and banks.
- **A further substantial tightening in global financial conditions and disorderly repricing in financial asset markets.** Inflation and interest rates remaining high for an extended period could lead to a significant deterioration in credit quality that could lead to lenders cutting back on the provision of credit. There could also be declines in asset prices that are sufficiently disorderly to disrupt financial system functioning. Vulnerabilities in NBFIs in key global financial markets, including shortcomings in the risk management of leverage and liquidity mismatches, could significantly amplify these abrupt adjustments in financial markets.
- **A sharp increase in unemployment and a slowdown in advanced economies.** While most banks are well placed to withstand a sharp economic slowdown, higher-than-anticipated loan losses resulting from rising unemployment could lead to a tightening in lending standards, amplifying the downturn. In some jurisdictions, weak conditions in commercial real estate (CRE) markets are likely to exacerbate banks' losses and impair credit provision. This is especially true for smaller US banks whose exposure to CRE loans is particularly large (around one-quarter of assets).

If these risks come to pass, their transmission to the Australian financial system could occur mainly through two channels:

1. A substantial tightening in global financial conditions and disorderly adjustments in asset prices could affect domestic funding costs and access to credit, and strain balance

sheets of financial institutions, households and businesses in Australia.

2. A sharp slowdown in global growth would impact Australia's growth via trade linkages, adding to difficulties for Australian households and businesses, some of which are already financially stretched. The nature of the underlying shock to global growth would determine the speed and magnitude of adjustment in Australia (which could play out unevenly for different sectors of the economy), though overall it is likely that nominal incomes would be lower and unemployment higher. This would challenge the debt-servicing capacity of the more vulnerable borrowers among Australian households and businesses.

While stress in overseas CRE markets could also spill over to Australia – reflecting an increase in foreign ownership over the past decade or so – the systemic risks to the domestic financial system arising from CRE developments are limited due to Australian banks' low exposure and conservative lending practices.

Most Australian households and businesses remain well placed to adapt to the challenging set of economic conditions, though some are vulnerable to further shocks.

A strong labour market and sizeable savings buffers have played a key role in Australian households' ability to adapt to a difficult economic environment. Most borrowers have been able to make adjustments to their finances as required, including by restraining their discretionary consumption, reducing their savings rates or even drawing down their stock of savings, and increasing hours worked. Incidences of severe financial stress are expected to increase but remain limited to a small share of housing borrowers.

Like households, businesses also benefited from the strong recovery from the pandemic. However, over the past year or so, the effects of inflation and higher interest rates have fallen unevenly. Ongoing cost pressures coupled with a recent softening in demand are putting pressure on some businesses' profits and liquid reserves, particularly in the construction, and arts and hospitality sectors. Corporate insolvencies have increased to around pre-pandemic levels, though most have tended to be small firms with little debt, limiting their broader impact on the economy and financial system.

The ongoing pressure on many households' and businesses' incomes and balance sheets has made them vulnerable to further shocks. In an adverse scenario where growth slows and unemployment rises more sharply than expected, loan losses for banks would increase. However, their provisioning and capital levels leave banks well placed to manage the increase in arrears, limiting the impact on credit provision in the economy and overall stability of the financial system.

Risks to financial stability are elevated but the Australian financial system remains strong.

Banks are at the core of the Australian financial system and remain well positioned to continue supplying credit to the economy despite elevated global and domestic risks; they are profitable and hold capital and liquid assets well in excess of regulatory requirements. Overall, Australian banks are in a strong position to raise provisions and absorb loan losses if economic conditions worsen more than expected. The very low share of borrowers in negative equity on their loans further protects banks against credit losses. Banks' funding sources are relatively stable, with a large share of domestic deposits, which are less susceptible to flight risk. This would leave them well placed if there were

to be disruptions to international funding market conditions. Furthermore, the risk of higher interest rates adversely impacting banks' balance sheets is proactively managed under the Australian Prudential Regulation Authority's regulatory regime.

In contrast to some advanced economies, systemic risks posed by non-bank financial institutions remain low in Australia. The financial stability risks arising from higher interest rates are more limited for domestic superannuation funds and insurers, compared with some peers abroad. The defined contribution superannuation funds that dominate the market for retirement savings in Australia pass asset price risk directly through to end investors (i.e. members), while domestic insurance companies tend to have little net exposure to interest rate risk due to the composition of their balance sheets and hedging of residual risk. Many non-bank lenders are experiencing a challenging environment for funding and/or asset quality; in aggregate, however, they pose limited systemic risk to the financial system owing to their small share of overall housing and business credit in Australia.

Strengthening institutions' financial and operational resilience to threats emanating from outside the financial system remains a regulatory priority.

There are several ongoing risks to financial stability originating from outside the financial system. These include the increasing intensity of cyber-attacks on financial institutions, the potential for an escalation in geopolitical tensions that results in severe disruptions to trade and international capital flows, and the effects of and responses to climate change (including disruptions to energy markets). These risks may also interact, adding to the uncertainty around how they might transmit through the financial system.

In response to this escalating threat environment, Australia's regulatory agencies have increased the intensity of their supervision of operational resilience among key financial institutions. It is important that Australian financial institutions continue to invest the time and resources required to enhance their operational defence and recovery plans in light of the heightened risk environment.