

Geopolitical Risk and Financial Stability

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Photo: da-kuk – Getty Images

Abstract

Geopolitical risk is becoming an increasingly important consideration for financial stability. This article sets out a structured framework to explain how geopolitical shocks could affect financial stability through a range of channels, from market disruptions to operational and security risks. The impact of geopolitical shocks is likely to differ from more traditional macro-financial stress in several ways, including by generating new operational challenges for the financial system – reinforcing the importance of robust contingency planning.

Introduction

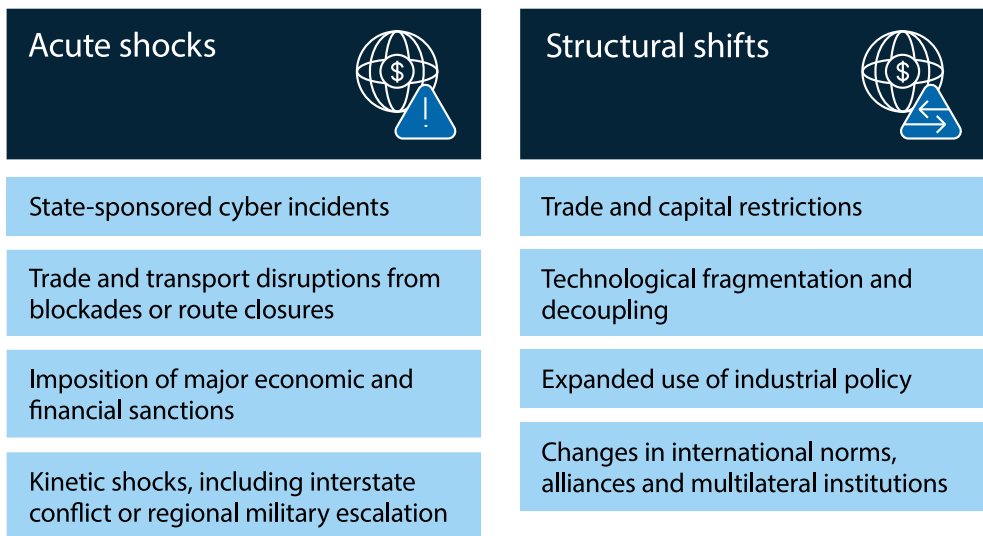
Heightened geopolitical tensions are an increasing focus for financial regulators and central banks globally.¹ Recent conflicts in the Middle East and Ukraine, and intensifying cyber-attacks by state-sponsored actors, have also prompted financial institutions to increase their focus on geopolitical risks. In Australia, the Council of Financial Regulators (CFR) is working with industry to ensure the financial system is prepared for a range of geopolitical scenarios.

This article sets out a structured framework that explains how geopolitical risks could impact financial stability. It aims to support financial institutions, market participants and the broader public in better understanding the potential impacts at an entity-specific and system-wide level, in turn helping to strengthen contingency planning.

For the purposes of this article, geopolitical risk is defined as ‘the potential for adverse impacts on the financial system from international tensions, including trade restrictions, sanctions, grey-zone activities and conflicts.’² This comprehensive definition extends beyond traditional financial risks, to also capture operational challenges and disruptions. While much of the existing analysis of geopolitical risk has focused on financial channels, this article adopts a broader, system-wide perspective.

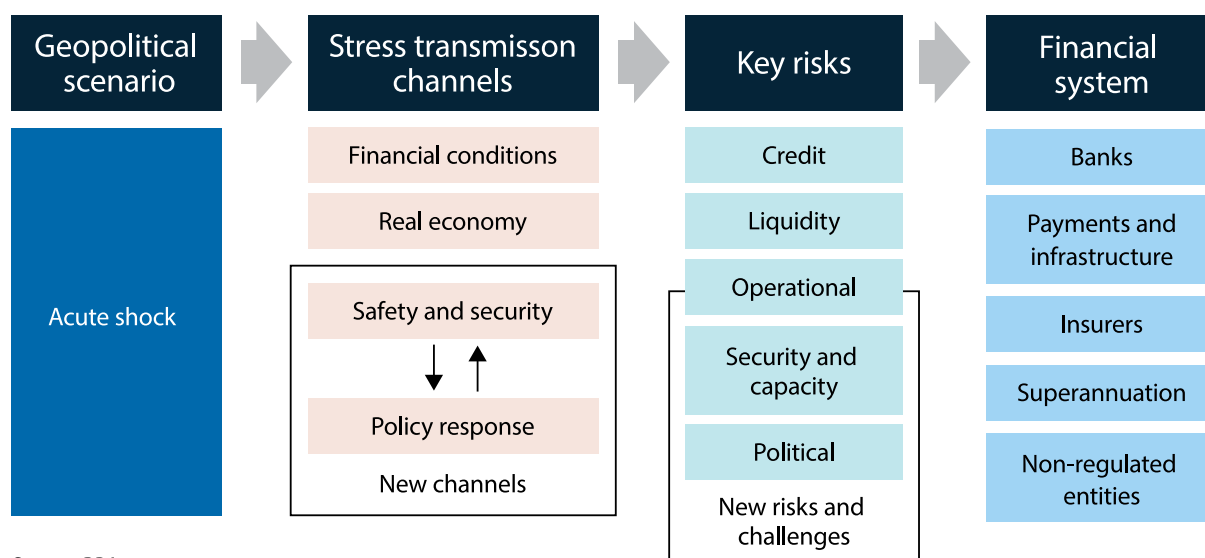
There are a wide range of potential geopolitical events and scenarios, which can make it challenging to identify and assess the risks. In considering geopolitical scenarios, it can therefore be helpful to distinguish between acute shocks and longer-term structural shifts. Figure 1 sets out this distinction with some illustrative examples, differentiating strategic changes that play out over time from acute shocks that can materialise quickly.³

Figure 1: Examples of Geopolitical Risk Scenarios



Source: RBA.

Figure 2: Geopolitical Risk Framework



Source: RBA.

A Geopolitical Risk Framework

The conceptual framework described in this article explains how geopolitical scenarios could impact the financial system, focusing on acute shocks rather than longer-term trends (Figure 2). The framework has been developed based on international precedents, and in consultation with other agencies on the CFR.⁴ It flows from the shock scenario to four key stress transmission channels and five material risk impacts.⁵ Highlighted in the framework are non-traditional channels, including safety and security and the international policy response, as well as new types of risk.

The impact of a geopolitical shock is likely to differ from more conventional macro-financial stress in several ways. As illustrated by the framework and accompanying assessment, a geopolitical shock could lead to:

- **Potential amplification of financial risks**, including faster liquidity shocks. For example, a disinformation campaign could trigger more rapid deposit runs than have been experienced in the past, and liquidity conditions in financial markets could deteriorate rapidly in an environment of significant geopolitical uncertainty.

- **Novel operational challenges for the financial system**, including security and political risks. These risks include the potential for insider threats and foreign interference, as well as the potential for disruption from financial sanctions and offshore asset seizures.⁶
- **Coordination challenges in crisis management**, given the potential for multiple financial and operational risks to be triggered at once. In such a scenario, financial institutions and regulatory authorities would need to prioritise responses across a wide range of different risks, maintain a clear understanding of what would be a volatile and ambiguous international policy environment, and ensure there is strong communication and engagement between the public and private sectors.

The framework is unpacked in the sections below, starting with an outline of the stress transmission channels and then presenting the key risks to the financial system that could emerge.

Stress transmission channels

Stress transmission channels show how shocks could transmit to the financial system through the behavioural responses of market participants, households and businesses. The geopolitical risk framework identifies four key stress transmission channels:

1. financial conditions
2. the real economy
3. safety and security
4. international policy responses.⁷

Financial conditions

The first transmission channel is through financial conditions, including in particular the potential for disorderly adjustments in asset prices. This channel is likely to respond most rapidly during a severe shock, as financial markets quickly adjust to changes in sentiment and the economic outlook. Geopolitical risk can affect financial conditions in several ways, including through:

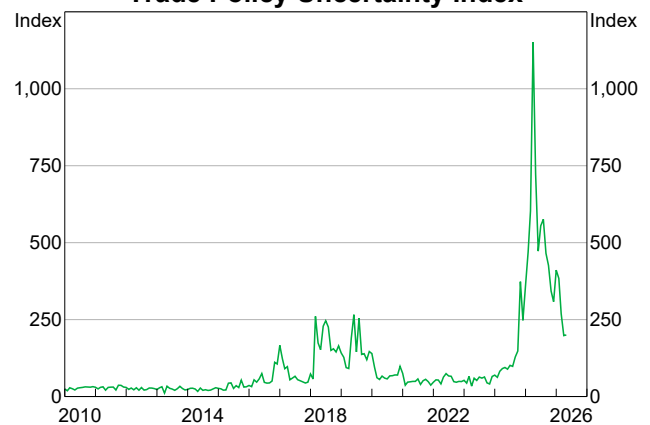
- **Increased uncertainty in financial markets**, which could undermine investor confidence and lead to heightened risk aversion. This may result in increased market volatility, disorderly price declines and a surge in trading volumes, potentially testing the capacity of financial market infrastructure.
- **Disruptions in access to funding**, impacting financial institutions that rely on international markets. Sovereign bond spreads may also widen in response to expectations of higher fiscal spending and increased risk premia, making it more difficult for governments to access capital in a time of need.
- **Reversals in capital flows**, which may lead to rapid adjustments in exchange rates and potentially exacerbate challenges in servicing and raising foreign-currency funding, and trigger the crystallisation of other latent vulnerabilities.

The real economy

The second transmission channel operates through the real economy. Geopolitical shocks can affect domestic economic activity in several ways, including through:

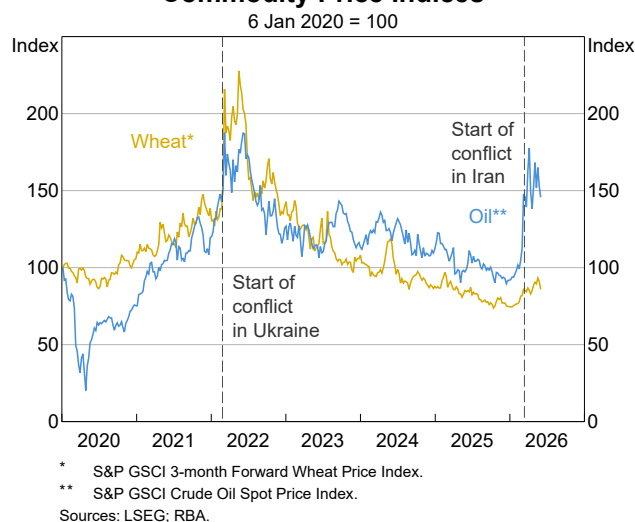
- **Trade restrictions**, such as tariffs and import quotas, which can limit market access for businesses and lead to higher prices for imported goods. Increases in global trade policy uncertainty, as shown in Graph 1, could weigh on economic activity and lead to higher unemployment.
- **Disruptions to the supply of key commodities**, such as crude oil, natural gas, fertilisers and staple foods, which could emerge during periods of heightened geopolitical tensions affecting major commodity-exporting or processing countries (Graph 2). All else equal, reduced supply would raise commodity prices, increasing business input costs and contributing to higher global and domestic inflation.
- **Dislocations in global supply chains**, if there was damage to logistics infrastructure, transport bottlenecks or blockades. Such dislocations could create product shortages and increase shipping costs, raising the prices of imported goods for domestic consumers and adding to inflationary pressures.
- **Heightened uncertainty**, which may dampen household and business confidence. This could lead households to reduce discretionary spending and businesses to delay or scale back investment, adversely affecting domestic economic activity.

Graph 1
Trade Policy Uncertainty Index



Sources: Caldara et al (2019); RBA.

Graph 2
Commodity Price Indices



Safety and security

The third transmission channel relates to safety and security, which may be impacted by nation-state actors as well as by malign non-state actors emboldened in a volatile environment. Stress may impact directly, such as through damage to critical national infrastructure, or indirectly, such as through disruption to offshore service providers. This channel includes:

- **Cyber-attacks on the financial system** that could disrupt financial services or result in financial losses. One notable example was the US\$81 million cyber theft from the Central Bank of Bangladesh in 2016, which has been widely attributed to the actions of a state-linked actor (ISACA 2023).
- **Disinformation campaigns** that seek to deliberately mislead market participants, erode confidence or weaken trust in financial institutions. For example, false information about the financial health of a bank could trigger deposit outflows, particularly where existing concerns are present. Disinformation has featured prominently in recent years, including during the military conflict in Ukraine (Broda and Stromback 2024). There is also likely to be increased fraud and scams activity in a heightened geopolitical risk environment.

- **Damage to critical national infrastructure**, which could impact power networks and undersea communication cables. Physical or digital attacks could result in service outages or degrade the performance of supporting payments infrastructure that is critical to the functioning of the financial system.

International policy responses

Finally, the fourth transmission channel is international policy responses by domestic and overseas governments.⁸ This channel is a distinctive feature of geopolitical scenarios: unlike in a conventional financial stress, where public sector actions typically cushion the impact, some policy responses directed towards geopolitical objectives could amplify economic and financial pressures. Such effects could arise in different ways, including:

- **Trade tariffs and capital restrictions**, which can raise import costs, contribute to inflationary pressures and shift cross-border investment. Over time, such measures may contribute to fragmentation in the international financial system (IMF 2023).
- **Financial sanctions**, which may generate compliance challenges for financial institutions, and could impact access to offshore funding markets and third-party service providers.⁹ Sanctions may also disrupt trade payments and other financial transactions, with spillover effects on financial markets and the broader economy.
- **Border closures and immigration restrictions**, which could constrain access to skilled labour. This may limit the ability of financial institutions to obtain specialised expertise, including in critical areas such as cybersecurity and operational resilience.
- **Exclusion from international financial infrastructure**, such as payment messaging systems. Recent examples include the exclusion of Iranian banks in 2018 and Russian banks in 2022 from SWIFT (Cipriani, Goldberg and La Spada 2023). Such measures, if broad-based, may accelerate financial fragmentation, as excluded countries seek to develop alternative financial infrastructure (Keskin 2025).

Early warning indicators

Given the wide range of channels through which geopolitical risk can transmit to the domestic financial system, it can be challenging to develop clear and comprehensive early warning indicators. Financial conditions are often the fastest to respond to geopolitical developments, but market-based measures may only react when events are perceived to have clear and immediate economic or financial implications.

As a result, periods of heightened geopolitical risk may not be fully reflected in asset prices or volatility measures until risks crystallise. Material geopolitical risks can therefore build while remaining only partially priced, increasing the potential for sudden and nonlinear adjustments when conditions deteriorate. Direct indicators of geopolitical risk, such as the Caldara-Iacoviello Geopolitical Risk index that uses newspaper text data, often measure levels of risk attention rather than the probability of shocks.¹⁰ They can, however, be useful when used in combination with other indicators.

Risks to the financial system

The stress transmission channels mapped out above would impact several core risk areas within the financial system. The framework identifies the following five risk types that would be most relevant in a geopolitical scenario:

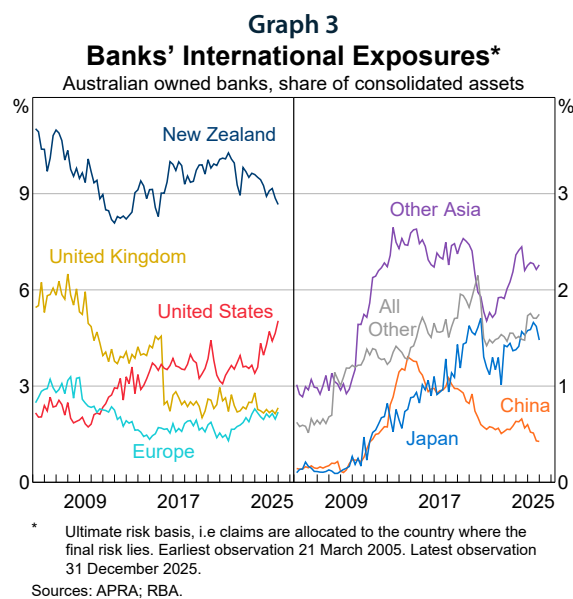
1. credit risk
2. liquidity risk
3. operational risk
4. security and capacity risk
5. political risk.

Stress transmission channels can impact multiple risk types, and do not map in a linear one-to-one manner. For example, the safety and security channel can give rise to operational disruptions, as well as security risks associated with foreign interference. This complexity highlights the importance of a clear framework for identifying and assessing the potential risk impacts.

Credit risk

Credit risk can materialise directly, through impacts on financial institutions' offshore lending and international investments. In aggregate, however, Australian banks' direct international exposures are relatively small, with approximately 15 per cent of total assets offshore (excluding New Zealand) (Graph 3).

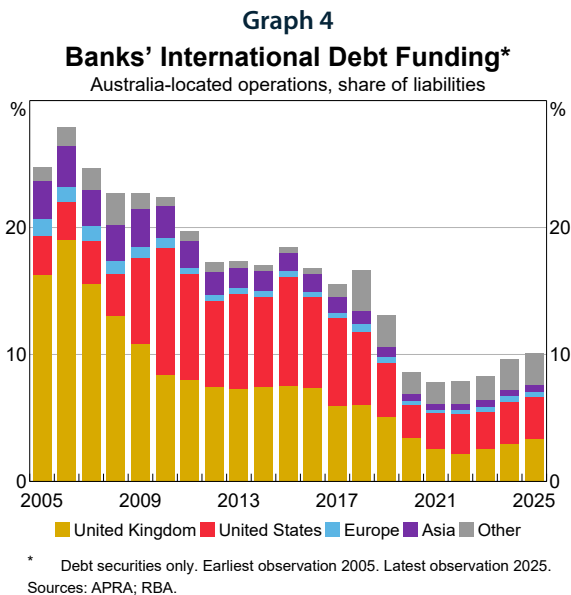
Credit risk can also materialise indirectly and, depending on the nature and persistence of a geopolitical shock, effects on the domestic economy could be material over time. In a severe scenario, international stress could transmit to the domestic economy through tighter financial conditions, adversely affecting economic growth, employment and property prices. If prolonged, this could lead to increased borrower stress and a rise in non-performing loans. Credit risk would likely emerge first in sectors most reliant on international trade, supply chains and migration flows, including transport, manufacturing, mining, energy and construction.



Liquidity risk

Liquidity risk could be elevated in a geopolitical scenario, and may be amplified beyond the levels of stress typical of a conventional financial shock. Heightened volatility in global financial markets could constrain Australian banks' ability to raise or roll over offshore funding, although reliance on international funding has declined since the global financial crisis (Graph 4).¹¹

A more acute risk in a geopolitical scenario is the potential for rapid deposit outflows, which could be triggered by concerns arising from disinformation, cyber-attacks or disruption to operations. For example, the 2025 geopolitical stress test by the Reserve Bank of New Zealand incorporated a 'name crisis' scenario that assumed significant deposit outflows alongside a loss of access to wholesale funding markets.¹² The assumed cash outflows in this exercise were materially higher than those underpinning the standard Liquidity Coverage Ratio (LCR). Maintaining prudent liquidity buffers and robust contingency funding arrangements are an important part of crisis preparedness for geopolitical risks.



Operational risk

Operational risk is the risk of loss or disruption to critical operations, which, in a heightened geopolitical risk environment, encompasses a wide range of vulnerabilities that could materialise. One of the most critical operational risks is the threat posed by sophisticated state-sponsored cyber-attacks; cyber operations have become a persistent feature of modern

statecraft and are increasingly used to influence geopolitical outcomes (Buchanan 2020). Operational disruptions could also arise from impairments to critical third-party service providers that support financial institutions, as well as from an elevated incidence of fraud and scams during periods of stress.

In addition, geopolitical scenarios may increase the risk of disruptions to retail and wholesale payment systems. For example, damage to critical national infrastructure, such as subsea cables that support international data transmission, could impair global communications and impact retail and wholesale payments. Strengthening operational resilience at a system level and maintaining effective fallback arrangements are important safeguards against such risks, and are therefore a key focus of the payments 'Industry Resilience Initiative' overseen by the Australian Prudential Regulation Authority (APRA) and the RBA (Jones 2025).

Security and capacity risks

Security risks are a subset of operational risks that warrant separate identification, as they are not typically considered in a traditional financial stability context. Security risks include the potential for insider threats and foreign interference. In extreme cases, insiders could sabotage core systems, steal data or compromise sensitive information. Foreign interference is a related but broader concept to insider risk, encompassing the risk of coercion or undue influence over an institution's governance, management or operations that could result in material disruption. Some international regulators have issued explicit guidance on integrity and security risks, including the Office of the Superintendent of Financial Institutions (OSFI) in Canada.¹³

Geopolitical developments can also give rise to organisational capacity risks, particularly where offshore teams or third-party providers are affected by conflict, disruptions or communication outages. At the same time, crisis conditions may require surge capacity in specialist functions, such as cybersecurity, sanctions compliance and legal risk management, placing additional strain on organisational resources.

Political risks

Political risks relate to the potential impact of international policy actions, including financial sanctions, capital controls and offshore asset seizures. Heightened geopolitical tension could result in broad-based or targeted sanctions being imposed rapidly by multiple jurisdictions. Differences in the scope, timing and design of sanctions regimes can create operational complexity and compliance challenges for financial institutions.

Beyond direct legal and regulatory risks, sanctions and other related policy measures could give rise to broader systemic implications, disrupting payment flows or constraining access to international funding and offshore third-party service providers. If severe or prolonged, such disruptions could undermine confidence in the financial system.¹⁴ Effective contingency planning is therefore essential to ensure institutions are able to adapt quickly to evolving international policy environments.

Conclusion

Geopolitical risk is an increasingly prominent concept in a financial stability context, encompassing a wide range of scenarios, transmission channels and impacts. A clear and structured framework can assist in identifying key stress transmission channels and assessing the material risks that may arise. As outlined in this framework, geopolitical scenarios may amplify financial vulnerabilities, present novel operational challenges and complicate crisis management, particularly where multiple risks crystallise at once.

Against this backdrop, authorities around the world are stepping up their efforts to ensure their financial systems are resilient to external shocks. In Australia, the CFR has been working with industry to strengthen resilience to a range of geopolitical scenarios. In addition, APRA, the RBA and the Australian Securities and Investment Commission are integrating geopolitical considerations into routine supervisory and oversight activities, to ensure that regulated entities continue to strengthen risk management practices and contingency planning.

Endnotes

- * The authors are from International Department and Financial Stability Department. They thank Troy Gill, Stefano Tornielli di Crestvolant and colleagues from across the RBA and other CFR agencies for helpful comments.
- 1 See, for example, ECB (2025a) and IMF (2025). APRA has highlighted that around 70 per cent of regulated entities have identified geopolitical risk as a key business risk over the next two years (APRA 2025).
 - 2 This definition of geopolitical risk refines concepts adopted by other international authorities. For example, the European Central Bank (ECB) defines geopolitical risk as ‘the threat, realisation, and escalation of adverse events associated with wars, terrorism, and any tensions among states and political actors that affect the peaceful course of international relations’ (ECB 2024). Grey-zone activities are coercive, non-military actions designed to achieve strategic objectives, while remaining below the threshold of open armed conflict.
 - 3 These can be related and interact with each other: acute geopolitical shocks are often linked to longer-term structural trends, and in turn, may act as catalysts for them. The ECB has set out a similar distinction between shocks and trends, further categorising these geopolitical risks into military conflict and war, infrastructure, trade, capital and finance, and politics and society. See ECB (2026).
 - 4 See, for example, the work of the ECB (2024), IMF (2023), DNB (2024) and ECB (2025b).
 - 5 The five core risk types are based on the material risks defined in APRA’s CPS 220 prudential standard (APRA 2017), and have been adapted to highlight those most relevant to a geopolitical scenario.
 - 6 ‘Foreign interference’ can be defined as the covert shaping of government or commercial decision-making to the advantage of a foreign power, contrary to domestic sovereignty and interests.
 - 7 The RBA has provided further analysis of the impact of overseas shocks on financial stability in Focus Topic 4.1 (RBA 2025).
 - 8 In addition, there would be likely to be a domestic policy response in such a scenario, including changes in fiscal and monetary policy.
 - 9 Sanctioned jurisdictions may also retaliate by seizing the assets of international banks operating within their borders. For example, Russia has undertaken retaliatory seizures of assets owned by foreign banks, including Deutsche Bank and Commerzbank (Al Jazeera 2024).
 - 10 See Caldara and Iacoviello (2022).
 - 11 Australian banks hedge their offshore funding into Australian dollars. Foreign-currency funding stress can be mitigated through functioning foreign exchange markets or activated central-bank swap lines.
 - 12 Nicholls and Adams-Kane (2025) set out details of the two severe but plausible scenarios that were tested in New Zealand.
 - 13 OSFI (2024) guidance sets out expectations for integrity and security for financial institutions in Canada.
 - 14 These risks can be amplified when difficulties in complying with sanctions prompt financial institutions to adopt an overly conservative approach, resulting in a broad ‘blast radius’ that affects a large cohort of customers and counterparties beyond those originally intended to be targeted.

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