1. The Global Financial Environment

The COVID-19 pandemic continues to constrain global economic activity and pose risks to financial stability. Since the previous *Review*, the balance of risks has shifted from the initial disruptions to financial markets toward the uncertain outlook for the economic recovery and so credit quality.

Financial markets became dysfunctional in March when the severity of the virus and the consequences for the global economy became apparent, initiating a sharp repricing of assets and heightened demand for liquidity. Market function was restored due to unprecedented policy responses by central banks, governments, prudential authorities and securities market authorities. Financial asset prices also rebounded, despite the subdued and still very uncertain economic outlook, prospects for widespread defaults and a range of international tensions that cover geopolitics, trade and technology. Lower incomes will create stress for a wide range of businesses, households and some governments, particularly those with high levels of debt.

Banks generally entered the crisis with substantially increased resilience, owing to regulatory reforms and changes in their business practices in the decade since the global financial crisis (GFC). Alongside substantial policy support, this has enabled banks to continue lending, which supports the real economy, even as expected credit losses and uncertainty have risen with the pandemic. However, lending standards have tightened and rising credit losses could test the willingness of some banks to continue lending – particularly those that already had low profitability or high non-performing loans (NPLs).

Bank profitability had been low in Europe and Japan for some years before the pandemic, and some euro area banks had been grappling with high NPLs. A large number of smaller Chinese banks had also appeared vulnerable to rising credit losses prior to the onset of the pandemic, with several banks requiring interventions by policymakers over the past year. Banks in a range of large emerging market economies (EMEs), mainly outside of Asia, also had high or rising NPLs. Many of these EMEs are being severely affected by the pandemic and they remain vulnerable to renewed capital flight.

Financial market function was restored with substantial policy support

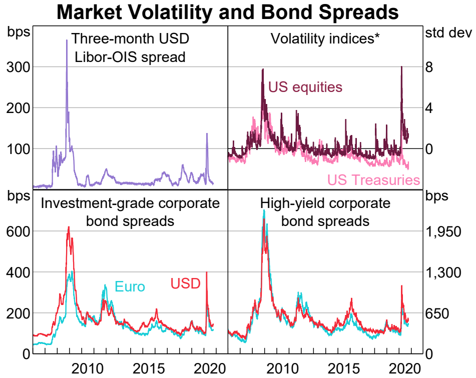
In March, the initial extreme uncertainty about the economic effects of COVID-19 triggered sharp falls in the prices of risky assets, increased demand for cash and caused market dysfunction, leading to a tightening in global financial conditions. Major global equity indices declined by around 35 per cent and high-yield bond spreads increased by 5.5 to 7.5 percentage points (Graph 1.1). The tightening in financial conditions was amplified by large-scale selling by some highly leveraged and open-ended investment funds (see 'Box A: Risks from Investment Funds and the COVID-19 Pandemic'). However, the policy responses by governments, central banks, prudential authorities and securities market authorities were rapid and unprecedented in scale and form, and were effective in stabilising financial market conditions and supporting economic activity.

Asset prices have rebounded, despite prospects for widespread defaults

There was a sharp recovery in risky asset prices and a compression in risk premiums, reflecting the policy response and expectations of sustained, very low risk-free interest rates. For instance, global equity prices have increased by around 35 per cent since their troughs, and some measures of equity valuations such as price earnings ratios have risen to high levels. The compensation for bearing credit and liquidity risks on corporate bonds has also narrowed sharply, though asset prices have decreased a little over the past few weeks. The rebound in risky asset prices occurred despite substantial uncertainty about the outlook for the pandemic and consequently for economic growth and business earnings. It may take a while for GDP in many economies to return to its pre-pandemic level, and some business closures will be permanent with higher unemployment likely to persist for some time (see the Bank's August 2020 *Statement on Monetary Policy*). This raises the potential for large losses for equity and debt investors.

Graph 1.1

Indicators of Financial Market Volatility and Bond Spreads



* Number of standard deviations away from historical median

Sources: Bloomberg; ICE Data used with permission; RBA

Some businesses will not recover

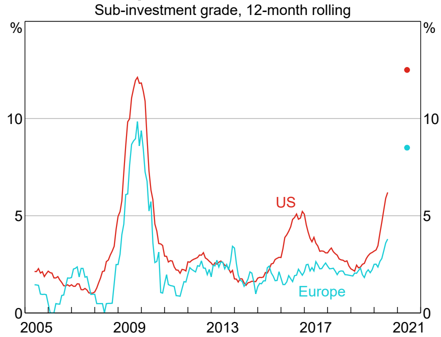
To cover cash flow shortages and build precautionary liquidity buffers, large corporations in advanced economies were able to draw on existing lines of credit as a precaution in the initial phase of the pandemic. They have also been able to issue significant volumes of bonds and new equity as market conditions have improved. Nevertheless, corporate default rates have risen and are expected to reach levels seen during the GFC (Graph 1.2). Similarly, delinquency rates have increased sharply for US commercial mortgage-backed securities, to be just over 8 per cent (up from around 1.5 per cent in February), given challenges being faced by hotels and shopping malls. Defaults are likely to accelerate in the period ahead, especially as debt repayment deferrals and other government support measures expire in the coming months.

Firms that operate in sectors hardest hit by the pandemic, and those with already low profitability and high debt levels are most vulnerable. Corporate debt had increased in the years prior to the pandemic in some economies, notably in Canada, France and the United States. There was also evidence of weakening in corporate credit quality – particularly in the United States, with the rapid expansion of 'covenant-lite' leveraged loans, which now

Graph 1.2

Corporate Default Rates*

Sub-investment grade, 12-month rolling



* By domicile of parent company; dots are S&P Global Ratings forecasts

Source: S&P Global Market Intelligence

account for about 85 per cent of US leveraged loans (Graph 1.3).

Prior to the pandemic, there had also been a deterioration of overall credit quality within the global investment grade corporate bond market. The share of BBB-rated bonds – the lowest investment grade rating – increased significantly. The prices of BBB-rated bonds will be sensitive to perceived risks of widespread credit rating downgrades if regulatory or mandate-constrained investors are required to sell. The investor base for high-yield bonds is relatively shallow, so a sudden surge in high-yield debt due to credit rating downgrades could inhibit the ability of high-yield borrowers to raise new debt, increasing rollover risks.

A large number of companies have had their credit ratings downgraded since March, but there was little effect on yields for other high-yield bonds and the pace of downgrades has slowed more recently. In part, this may be because some central banks, such as the European Central Bank and the US Federal Reserve, have expanded eligibility of their facilities to a broader range of corporate bonds. For example, these central banks will use pre-pandemic ratings when deciding whether to accept collateral.

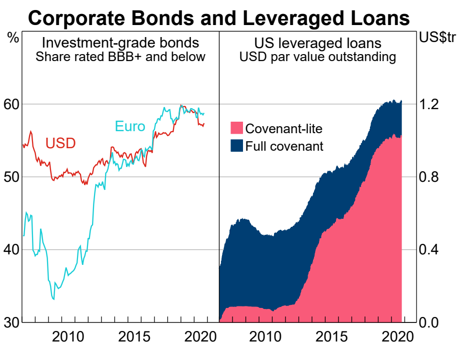
In China, corporate debt has continued to grow, to be 160 per cent of GDP in the June quarter, which is high relative to other countries at similar levels of development (Graph 1.4). As in other economies, regulators in China have encouraged an increase in corporate borrowing in response to the pandemic. This includes mandating an increase in bank lending to micro- and small-enterprises (MSEs) at favourable interest rates and loan forbearance until March 2021, which has limited the increase in NPLs.

The health of local government balance sheets in China also remains a concern. Local governments are once again playing a large role in funding fiscal stimulus with the quota for local government special bond issuance 75 per cent higher in 2020 than in 2019. The stock of off-balance sheet borrowing by local governments, which lacks transparency, also remains significant. In addition, the finances of local governments are vulnerable to a deterioration in housing market conditions due to their reliance on revenue from property taxes and land sales.

Political tensions have implications for both the global economic recovery and the financial system

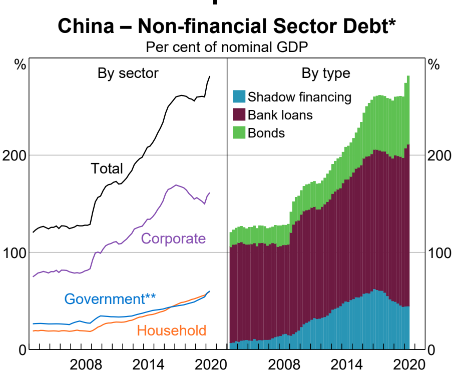
There has been a rise in international tensions – covering trade, technology and international and national political disputes – which has the potential to significantly constrain the global economic recovery and impede the functioning

Graph 1.3



Sources: ICE Data used with permission; JP Morgan; RBA

Graph 1.4



* Includes RBA estimates of shadow financing that is not included in total social financing

** Includes some borrowing by local government financing vehicles

Sources: BIS; CEIC Data; RBA; WIND Information of the global financial system. For example, rising international tensions, notably between the United States and China, increases the risk of abrupt and broad-based disruptions to global supply chains and trade. This could generate losses for lenders and other asset owners exposed to affected businesses. The indirect effects, through weaker confidence, investment and growth, would likely be even larger for the financial system.

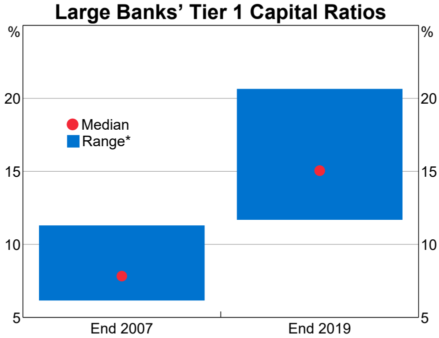
Globally, banks are more resilient than in the past but there are risks

Most banks entered 2020 with high levels of capital and liquid assets, which had increased with the regulatory reforms that followed the GFC. At the end of 2019, the median Tier 1 capital ratio of large banks in advanced economies was 15 per cent (Graph 1.5). These buffers, alongside the substantial policy response, have enabled banks to support economic activity by continuing to extend credit to businesses and households.

Internationally, regulators have taken action to support banks' capacity and incentive to lend and maintain other critical functions. Actions have included: adjusting or releasing capital and liquidity buffers; restricting capital distributions and discretionary pay; clarifying that deferred loans should not automatically be classified as non-performing; and providing information on how banks should approach the accounting issue of provisioning against future losses in a time of considerable uncertainty. Regulators have also emphasised that buffers are designed to be drawn down during times of stress. Some authorities have adjusted the calculation of regulatory capital, including temporarily easing the leverage ratio rule to support banks' capacity to act as intermediaries between buyers and sellers in financial markets. Other central bank actions, including various term funding schemes, have lowered banks' funding costs and supported their liquidity.

Graph 1.5

Large Banks' Tier 1 Capital Ratios



* 5th to 95th percentile of Tier 1 capital ratios across 74 large advanced economy banks from Australia (4), Canada (6), United Kingdom (4), United States (10), Japan (4), euro area (34) and other Europe (12)

Sources: RBA; S&P Global Market Intelligence

Banks in many jurisdictions have offered repayment deferrals to borrowers affected by the COVID-19 pandemic. The amount of this forbearance varies, reflecting the extent of the economic contraction, the nature of borrowing and the terms of forbearance offered in individual countries. In many large advanced economies, between 5 and 10 per cent of loans at large banks were subject to forbearance as of mid 2020.

Several factors lower the direct risks to banks from these deferred loans. In many economies banks have provided higher rates of forbearance on residential mortgages, which are often lower risk than other types of lending. In addition, some borrowers with deferred loans have continued to make loan repayments and there has also been a reduction in loans in forbearance in recent months due to the recovery in economic conditions. Nevertheless, some banks' capital positions will be eroded by the unwinding of favourable regulatory treatment if they continue to provide forbearance, and this will start to occur in some countries by the end of 2020 (including in Canada, the United Kingdom and the United States).

Most banks have so far remained profitable, partly as a result of extensive policy support for households and businesses (Graph 1.6). This is despite recording increased impairment expenses to account for higher expected loan losses (Graph 1.7). The extent of the increase in provisions has varied by jurisdiction, with differences partly explained by differences in the expected economic impact of the pandemic. US banks have increased provisions by more than banks in other large advanced economies, including Australia, in part because of more stringent accounting standards that were implemented in the March quarter of 2020.

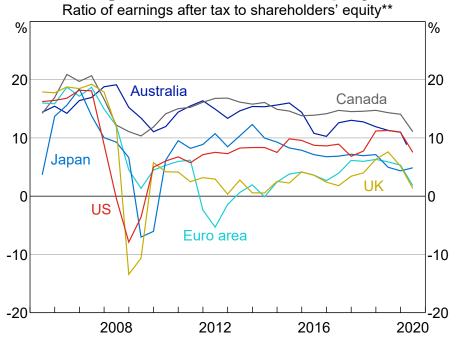
Many central banks and prudential regulators have undertaken bank stress tests using baseline and more extreme economic scenarios. As with previous stress tests, the results suggest most banks will be resilient and hold sufficient capital buffers to absorb the loss levels implied by these scenarios without breaching minimum regulatory requirements. However, the high degree of uncertainty surrounding the economic outlook means that losses could exceed banks' current provisioning and in downside scenarios some banks would likely need to replenish capital to avoid capital ratios approaching minimum requirements.

Uncertainty around the outlook for credit quality may cause banks to restrict lending, particularly to new and more risky borrowers. Indeed, bank lending standards have already tightened in some jurisdictions (Graph 1.8). This is despite the majority of global banks having substantial capital buffers that are well in excess of regulatory minimums and regulatory guidance that banks should use their capital buffers to support lending (see 'Box C: The Use of Banks' Capital Buffers'). One notable exception is business lending in the United Kingdom where temporary government guarantee programs led to a substantial easing in lending standards in the second quarter of 2020. The continued provision of credit by banks is crucial for supporting the recovery and limiting the depth of the global recession.

Graph 1.6

Large Banks' Return on Equity*

Ratio of earnings after tax to shareholders' equity**



* Number of banks: Australia (4), Canada (6), euro area (39), Japan (4), United Kingdom (4) and United States (12)

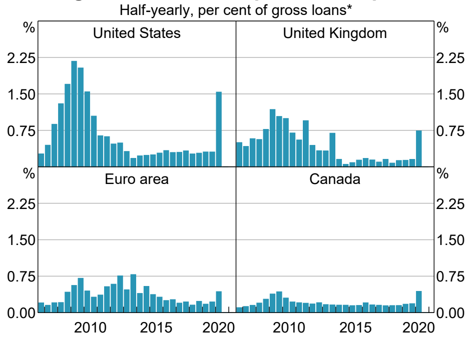
** Excludes minority interests; reporting periods vary

Sources: APRA; RBA; S&P Global Market Intelligence

Graph 1.7

Large Banks' Loan Impairment Expense

Half-yearly, per cent of gross loans*



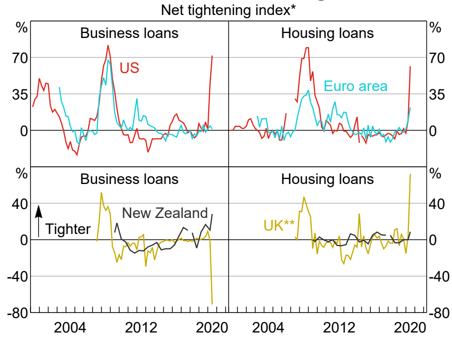
* Number of banks: United States (10), United Kingdom (4), euro area (36), Canada (6)

Sources: RBA; S&P Global Market Intelligence

Graph 1.8

Advanced Economies' Lending Standards

Net tightening index*



* Net fraction of banks reporting a tightening of standards; New Zealand and United Kingdom data are market share-weighted

** Includes other types of household secured lending

Sources: Bank of England; RBA; Refinitiv; Reserve Bank of New Zealand

Some banking systems are facing greater challenges because of pre-pandemic vulnerabilities

For banking systems with a history of low profitability, notably in the euro area and Japan, share price valuations have fallen from already low levels since the start of the pandemic. Aggregate price-to-book ratios in the euro area and Japan have fallen to around 0.4 (Graph 1.9). An extended period of very low interest rates, and compressed net interest margins, would further weigh on banks' profitability, particularly for banks that rely heavily on retail deposits for their funding. Low profitability means it will take longer to replenish capital to pre-COVID-19 levels and it will be more expensive for affected banks to raise capital. This could lead banks to reduce lending to preserve capital, which would hinder the broader recovery in these economies and place further pressure on capital positions.

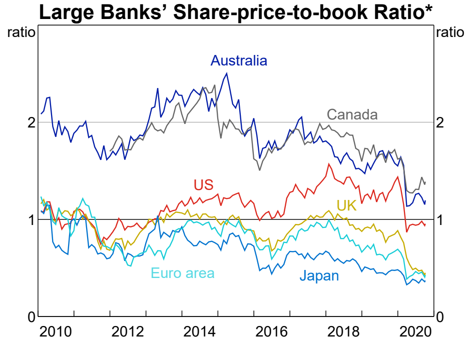
Structural challenges at European banks associated with high operating costs, subdued revenue growth and overcapacity within the banking sector have contributed to low profitability for some years. Many European banks also entered the pandemic with high levels of NPLs. In addition, banks in the euro area hold large amounts of sovereign bonds issued by their home government, which makes banks vulnerable to any emerging concerns about debt sustainability. The recent announcement of the European Union's €750 billion European Recovery Fund, under which member countries agreed to pool risk and jointly issue debt, may mitigate some of this sovereign debt risk by reducing the amount of debt that individual countries issue themselves.

In China, banks generally remain profitable and have supported the economy by providing forbearance on loans to MSEs and continuing to lend (Graph 1.10). This has been assisted by increased funding from the People's Bank of China at low interest rates and an easing of regulations, including lower minimum provisioning requirements and delayed recognition of NPLs. However, credit losses have risen and banks have increased provisions in anticipation of higher losses. This is being compounded by increased lending to MSEs, which have relatively high default risks because of their concentrated revenues and smaller liquidity buffers. The authorities have also directed banks to lower their profits to benefit the real economy.

While large banks' reported capital ratios are well above regulatory minimums, a range of smaller banks have thin buffers, are disproportionately exposed to MSEs, have higher NPLs and are more exposed to China's opaque shadow

Graph 1.9

Large Banks' Share-price-to-book Ratio*

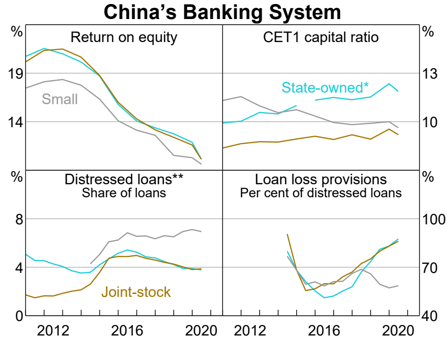


* Weighted average; number of banks: Australia (4), Canada (6), euro area (26), Japan (4), United Kingdom (4) and United States (12)

Sources: RBA; S&P Global Market Intelligence

Graph 1.10

China's Banking System



* Break for state-owned banks in 2015 reflects the change to internal ratings-based approach for risk-weighted assets

** Include non-performing loans and special mention loans

Sources: CEIC Data; RBA; S&P Global Market Intelligence banking system. Over the past year, at least seven small banks are reported to have experienced deposit runs and at least 12 banks have been involved in mergers and restructurings, some of which were because of issues with asset quality and corruption.

While policymakers have been successful in shrinking China's complex and riskier shadow banking system and reducing its direct links to the banks in recent years, risks remain elevated. Defaults have materialised at some Chinese trust companies over the past year as authorities have attempted to wind back perceived implicit guarantees. However, the scale of defaults in the shadow banking sector has remained very small to date. The implementation of asset management regulations – which address risks related to implicit guarantees, liquidity, leverage, contagion and regulatory arbitrage – was further delayed by one year.

Banks have handled the disruptions to their operations well

The pandemic and related containment measures have increased operational risks, with large numbers of staff still working from home or working in separated shifts and sites. While operational arrangements have generally worked well to date, the risks associated with operational capacity, technology failure and cyber attacks remain heightened.

Delays in the transition away from London Inter-Bank Offered Rates (LIBOR) also create risks. If the transition is not finished before the end of 2021, significant reputational, operational and legal risks to financial institutions could be realised. Authorities are continuing to encourage the private sector to transition away from LIBOR and adopt definitive contractual fallback clauses for legacy contracts (discussed further in 'Chapter 4: Regulatory Developments').

Insurers and central counterparties (CCPs) have generally been resilient though there are some risks

Insurers and reinsurers are generally well capitalised and should be able to meet the higher claims expected due to the pandemic. Many insurers excluded pandemics from coverage in their policies, which will limit the size of total claim losses. However, ambiguous contract wording could mean that some insurers are more exposed than expected, though legal test cases are being used to resolve some of this ambiguity. Long-term interest rates are expected to remain at very low levels for a considerable period of time, reducing insurers' return on assets and so profits. They are also increasing the risk of insolvency for some life insurers and for defined benefit pension funds that previously agreed to pay guaranteed benefits to policyholders based on higher interest rates.

Insurers are also exposed to the effects of climate change, including through higher potential claims and losses on financial investments. A range of insurers are acting to reduce these risks, though some actions will have negative effects (such as significantly higher insurance premiums or withdrawing coverage of certain risks).

CCPs have operated effectively, including throughout the period of market dysfunction in March. Initial and variation margin requirements rose in response to higher asset price volatility, which mitigated counterparty risks but contributed to the increased demand for liquidity. While most participants at CCPs were able to meet these increased margin requirements, there were a small number of participant and client defaults globally, though none in Australia. These events were managed without any loss to the CCPs or their other participants. Initial margins have remained higher than before the pandemic.

Some EMEs remain vulnerable to capital outflows and rising credit losses

EMEs (excluding China) experienced unprecedented portfolio outflows in March, leading to sharp currency depreciations and a material tightening in financial conditions (Graph 1.11). In response, some central banks sold foreign currency reserves to support their currencies and purchased local currency government bonds, which have assisted domestic market functioning. Financial market conditions have improved since March, though in recent weeks exchange rates have depreciated and local and foreign currency bond yields have started to rise again.

EMEs continue to face risks, particularly from unhedged foreign currency debt and weak economic outlooks, which, if realised, would lead to increased loan losses at banks. The International Monetary Fund (IMF) has provided emergency assistance to 81 EMEs for balance of payments support in the wake of the pandemic.

In Asia (excluding China), most EMEs entered 2020 with relatively strong macroeconomic fundamentals and banking systems that were generally well capitalised, had adequate liquidity and low NPL ratios (Graph 1.12). As a result market conditions have been more stable than for EMEs in other regions. Authorities have responded to the shock with a range of policy measures including term lending facilities to support the flow of credit to businesses, loan repayment holidays and loan guarantees. The central banks of Indonesia and the Philippines have provided direct financing to their governments to support fiscal packages.

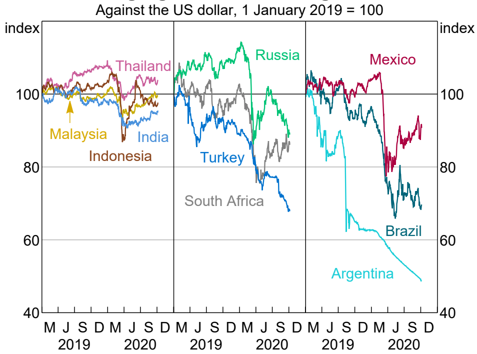
Indian banks entered the year in a weaker position, with elevated NPL ratios and low profits (especially at public sector banks) even before the onset of the pandemic. The pandemic is placing renewed pressure on Indian banks at a time when government finances are under strain. Non-bank financial companies are also facing deteriorating asset quality. They have obtained a greater share of their funding from banks since the pandemic began, which increases the potential for losses to flow through to banks.

Some large EMEs outside Asia already had elevated vulnerabilities, which are being exacerbated by the pandemic. Turkey has experienced capital outflows that contributed to an exchange rate depreciation and increased the cost of servicing liabilities that are denominated in foreign currency (most of which is owed by the private sector). Foreign currency reserves have also fallen to low levels. Brazil and Russia have seen large declines in the value of their currencies this year, of around one-quarter,

Graph 1.11

Emerging Market Exchange Rates

Against the US dollar, 1 January 2019 = 100

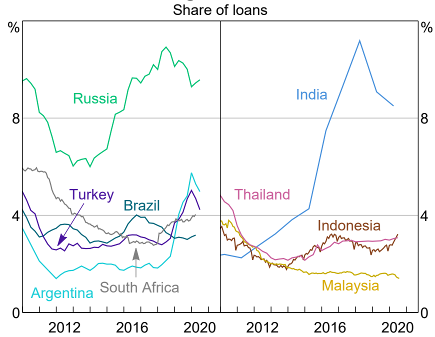


Source: Bloomberg

Graph 1.12

Banking Sector NPLs

Share of loans



Sources: CEIC Data; IMF

which has prompted their central banks to intervene by selling foreign currency reserves.

South Africa had vulnerabilities prior to the pandemic, including weak growth, high government debt and a large fiscal deficit. The IMF has approved US$4.3 billion in emergency support for South Africa, which will help to alleviate external pressures. Argentina has formally requested further assistance from the IMF, having previously reached an arrangement with bond holders to restructure the vast majority of its foreign currency debt. Yields on the restructured debt have already increased sharply.