Overview

Financial systems in Australia and internationally are resilient but face substantial risks

The COVID-19 pandemic is an enormous health and economic challenge that raises significant risks for financial systems around the world, including in Australia. The substantial economic contraction in the first half of 2020 was the largest in most economies since the Second World War.

After a period of heightened volatility and stress following the onset of the pandemic, financial systems have continued to operate effectively. Banks and financial markets withstood the initial liquidity phase of the crisis, given banks' large liquid asset holdings and central banks' substantial injections of liquidity.

With economies experiencing large contractions in output, the focus has shifted from liquidity to the solvency of borrowers as expected defaults will result in credit losses for lenders. The global economic recovery is going to take time and will be uneven. Its path is also highly uncertain, and dependent on the further course of the virus. Risks to financial systems will therefore remain elevated for some time to come.

Over the past six months financial markets have continued to operate effectively with no repeat of the heightened volatility and illiquidity seen in February and March. Financial asset prices have rebounded after falling sharply and, in many cases, are back around pre-COVID-19 highs. In part, this reflects an expectation that policy interest rates will remain low for an extended period of time. Also, measures of compensation for taking risk – for example credit spreads – have retraced most of the sharp increase that occurred in March. This is in contrast to the expectation of most forecasters that output will not quickly return to pre-pandemic levels, and that corporate defaults will rise. Together these facts imply a potential for compensation demanded for risk to jump, and so for asset prices to fall sharply.

Globally, including in Australia, banks entered the pandemic with substantially higher levels of capital and holdings of liquid assets than prior to the global financial crisis (GFC). This balance sheet strength has enabled banks to absorb shocks, rather than amplify them as they did in the GFC. Banks have continued to lend, including enabling businesses to draw down lines of credit as a precaution early in the crisis. They do, however, face the prospect of sharp rises in borrower defaults.

Other parts of the financial system have also withstood the impact of the crisis. Central counterparties have continued to operate effectively without any major incidents despite the substantial volatility in financial markets and disruptions to working arrangements. Investment funds have generally been able to meet customers' claims, partly due to the quick recovery in markets, and so have not been a persistent amplifier of liquidity shocks. Some funds internationally, however, now have depleted liquid asset holdings and an unwinding of leverage at some funds contributed to dislocation in government bond

markets in March. The rebound in asset prices has benefited insurance companies, though some will face pressures from low interest rates and, for some, their liability for businesses' losses from the pandemic is unresolved. In Australia, superannuation funds have successfully managed the large early release of funds to households without notable impacts on markets.

Despite the general resilience of the global financial system overall, there are areas where risks are particularly elevated. Some pre-existing risks are specific to particular economies: high levels of debt in household and business sectors in some economies could result in large credit losses for banks; in some European countries there is an intertwined risk from low bank profitability and high government debt; in some emerging market economies banks entered the crisis with low profitability while the economic contraction could be particularly large given weaker health systems and so health outcomes and less space for fiscal stimulus. Some other risks are common to financial institutions globally, in particular increasing cyber risks from sophisticated criminal and state-sponsored groups, and the long-term risks from climate change.

Australian businesses and households are generally in a strong financial position but some will struggle in the near term

In Australia and many other economies, households and businesses that have faced a loss of income have been able to defer loan repayments until later this year, or in some cases into next year. This has helped to avoid defaults by borrowers who should be able to resume repayments when economic conditions improve. In doing so, these deferrals avoided asset fire sales, supported businesses so that they can continue to employ people and, in doing so, avoided the unnecessary impairment to household and business balance sheets that would have adverse long-run consequences. Loan repayment deferrals have been feasible because of banks' balance sheet strength, flexible regulatory treatment and very low interest rates, which mean the impact on banks' cash flow and borrowers' loans balances is relatively small. It is, though, important that there is transparency around loan performance and that borrowers engage with their bank and resume repayments as soon as possible. Banks need to deal carefully with the loans of borrowers who will not be able to resume repayments, in a way that balances avoiding further losses to the bank, the interests of the borrower and potential spillover effects from any sales of collateral.

Australian businesses generally had low levels of debt going into the crisis. Income support measures, rent relief and loan repayment deferrals have helped maintain cash flow despite the sharp reduction in revenue experienced by many businesses. These measures, in conjunction with temporary insolvency relief, have seen business failures trend lower this year. Continued availability of equity and debt funding has enabled large businesses to shore-up their balance sheets. However, business failures will rise substantially as loan repayment deferrals and income support come to an end. Business failures have flow-on effects to their creditors, both financial institutions and other businesses, and their employees.

Overall household income in Australia increased in the first half of the year, with large fiscal stimulus payments more than offsetting the decline in employment income. Households' cash flow also benefited from loan repayment deferrals and the early release of funds from superannuation. Households have increased their savings buffers in response to increased economic uncertainty, including through payments into mortgage offset and redraw

accounts. However, with unemployment having increased and many employees working reduced hours, the number of households experiencing financial stress has increased and will increase further.

Some households are struggling, but the finances of most households are faring well to date and demand for housing has held up. Housing prices in Sydney and Melbourne have fallen only a little, with larger falls in inner city areas. While credit is available at very low interest rates, reduced housing demand from very low immigration and the rise in unemployment contribute to the risk of further falls in housing prices. This increases the potential for losses for lenders in the event of a rise in distressed sales.

Some commercial real estate also poses significant risks for lenders and leveraged investors. Prior to the pandemic, structural change in the retail sector was contributing to rising retail property vacancy rates and falling valuations. This process has accelerated given mobility restrictions and voluntary physical distancing during the pandemic. Conditions in office markets had been tight prior to the crisis, particularly in Sydney and Melbourne. But with the current economic downturn and changing expectations of future office use, conditions have deteriorated somewhat with rising vacancy rates and expectations of declining capital values. In contrast, demand for industrial property has remained strong, including because of online shopping.

The Australian financial system has the strength to withstand the economic downturn and support the economic recovery

Globally, financial systems have cushioned rather than amplified the pandemic shock. This positive outcome has reflected several factors: banks are more resilient following the reforms that followed the GFC, which in particular boosted their capital and liquidity; policymakers have taken unprecedented actions to support their economies and financial systems; and, in contrast to what occurred during the GFC, confidence in banks has remained high as they were not the source of the shock.

Australian banks have high capital levels, are profitable and most of their loans are well secured. Banks' capital has been supported by retaining a higher share of earnings, for which there was guidance from the Australian Prudential Regulation Authority (APRA). The Bank, APRA, the Australian Securities and Investments Commission and the Treasury have intensified their collaborative work through the Council of Financial Regulators to effectively support the financial system during the pandemic.

While the Australian financial system is in a strong position, risks are elevated. These risks to the financial system would be exacerbated by a weaker-than-expected economic recovery, for example, stemming from further setbacks on the health front or international political tensions. However, stress tests of the Australian banking system indicate under a baseline scenario based on the economic forecasts in the Bank's August 2020 *Statement on Monetary Policy* (SMP) banks will remain very well capitalised, not even entering their capital conservation buffers. Even if the economic contraction is substantially more severe under a downside scenario, banks would remain above their minimum capital requirements. Given their strong balance sheets, banks will be well placed to continue lending, supporting the economic recovery and so in turn the Australian financial system.