Overview

Financial systems globally have been resilient to a substantial shock

Financial systems in Australia and internationally have been resilient to the enormous COVID-19 health and economic shock. This has enabled them to cushion the economic impact of the pandemic, supporting the recovery through new lending and measures such as loan repayment deferrals. The financial sector reforms that followed the global financial crisis greatly contributed to this positive outcome. Banks hold substantially more high-quality liquid assets and have much higher levels of capital than a decade ago. Substantial policy support from governments, central banks and other regulators has also underpinned the resilience of the financial system over the past year. Fiscal support has sustained economic activity and improved the finances of borrowers, and so loan performance, and central banks have eased monetary policy and maintained market liquidity in key debt markets. Financial regulators have also employed flexibility in the regulatory framework, for example by providing temporary capital relief if banks extended payment deferrals to customers affected by the pandemic.

The Australian banks are in a strong financial position coming out of the pandemic. Their profitability recovered in the second half of 2020, after banks increased their provisioning for expected loan losses in the first half, and analysts expect profitability to strengthen further in 2021. Banks' non-performing loans have increased, but by less than expected, and their current provision balances are expected to be sufficient to absorb the impact of future defaults.

Globally, ongoing fiscal stimulus, the rollout of COVID-19 vaccines and very accommodative financial conditions are contributing to the economic recovery that started in the second half of 2020. There is still substantial underemployed labour and capital, but the strong rebound in economic activity greatly reduces the risk of a sustained deep global recession that would be very damaging for financial institutions. Accommodative financial conditions, including policy interest rates that central banks have committed to keep very low for several years, and expectations of a sustained recovery in activity in most economies, have contributed to rising asset prices, and indebtedness in some sectors. If risk premiums were to rise from low levels, then long-term bond yields could jump higher, leading to falls in a broad range of asset prices that are underpinned by the low level of risk-free interest rates.

Key risks to financial stability are similar in Australia and internationally

An incomplete, or very uneven, economic recovery would present risks to financial stability

If incomes remain below pre-pandemic levels in some countries, as government support is wound back, it increases the likelihood that some borrowers will struggle to make their debt repayments, exhaust their financial buffers and consequently default. Slower growth would also impede the ability of banks that had low profitability before the pandemic – in particular some in Europe and Japan – to generate new capital, and so weigh on their resilience to losses and willingness to lend. Delays in widespread vaccination, or a reduced efficacy of available vaccines, are a crucial factor that could stall the economic recovery. But even if the recovery in aggregate activity proceeds broadly as expected, an uneven recovery with some parts of the economy continuing to be constrained by the virus would still cause significant losses for lenders exposed to those sectors.

Some emerging market economies (EMEs) are exposed to risk from tightening in financial conditions in advanced economies, particularly if their own recovery is lagging. Historically, financial dislocation in EMEs has coincided with rising global interest rates. In addition, slower rollout of vaccines and pre-existing macroeconomic and financial imbalances are impeding the recovery in some EMEs, with output not expected to return to pre-pandemic levels for several years. These EMEs could then face sharp capital outflows, exchange rate depreciations or unhelpful increases in their domestic interest rates. Sharp financial adjustment and disruption in large EMEs could also result in losses for exposed investors and financial institutions in advanced economies.

Cyclically low interest rates and rising asset prices create a risk of excessive borrowing

A range of asset prices, both globally and in Australia, have been rising – a channel through which expansionary monetary policy stimulates economic activity – and some appear high relative to their expected future stream of income. However, for most financial and real assets, this lower rate of expected earnings relative to the asset price is broadly consistent with the very low level of interest rates. For example, for equities while the price-earnings ratio is high in some markets, the equity risk premium is more in line with its value in recent years. Housing prices in many economies have been rising, at a faster pace from the second half of 2020, which has mitigated the risk earlier in the pandemic that falling prices would result in significant losses on mortgage lending. In Australia, housing prices have recorded strong growth in recent months. To date the growth in asset prices has not been associated with a significant increase in the growth of debt.

However, globally risks associated with asset prices and debt could build. A sustained period of rising asset prices may lead to over-exuberance and extrapolative expectations, with increased risk-taking and leverage in an environment of accommodative financial conditions. In this situation lending standards could weaken, with asset prices being pushed above their fundamental values. A correction in asset prices, if borrowers' income were to fall and so they defaulted on debt repayments, would expose lenders to large losses on the increased debt, particularly if the quality of that debt had been eroded.

The risks are higher from some specific leveraged assets. In a number of economies, including Australia, housing price growth (and to a lesser extent housing borrowing) has picked up notably in recent months and is being watched closely by regulatory authorities. Globally, the pandemic has accelerated structural change in the retail sector, including increasing online sales, leading to falling retail commercial property prices, while demand for office property is uncertain given changing work practices. The pandemic has also created more specific challenges for some types of assets. For example, in Australia, the decline in immigration and preference changes has introduced additional uncertainty for apartment prices, particularly in inner city areas.

In an environment of accommodative financial conditions with rising asset prices it is particularly important that there is not excessive risk-taking by the financial sector. Increased risk-taking by lenders could take the form of looser lending standards for individual loan assessments, or a relaxation of internal limits on the share of riskier loans they make. Even if lenders do not weaken their own settings, increased risk-taking by optimistic borrowers could see a deterioration in the average quality of new lending. This would weaken the resilience of businesses and households, and so the financial system, to future shocks. Increased risk-taking would fuel rising debt, from already high levels, increasing the debt-related risks to the economy and financial system from a fall in asset prices and borrowers' income. The improvement in lending standards in Australia for property from the mid 2010s helped to ensure borrowers were well placed to weather the economic shock over the past year, demonstrating the benefits to the financial system and the economy of appropriately controlling risks.

Cyber attacks are a growing risk for financial stability

Over the past 6 months there have been several high-profile cyber attacks worldwide. While financial institutions were not specifically targeted by these attacks, some were affected. These attacks have demonstrated the increased sophistication of perpetrators. Financial institutions globally typically rate cyber as one of the most substantial risks they face. Large financial institutions, which are more systemically important, have the scale for substantial investment in cyber security. However, with a very large and increasing number of attacks, there remains the likelihood that even large financial institutions or critical financial market infrastructure will at some point be impacted, including via third-party providers. Substantial cyber attacks could risk financial stability if, for example, they corrupt significant data or if they affect large parts of the financial system or critical nodes. Given this, it is crucial that financial institutions and systems not only take preventative actions, but enhance resilience by planning recovery actions to cyber security breaches.