Overview

Global financial systems have continued to function well over the past six months with further waves of COVID-19 having limited impacts on financial institutions and markets. A new source of uncertainty has been Russia's invasion of Ukraine, which has accentuated some existing risks in the global financial system and created others. Commodity prices have increased sharply and there has been an increase in market volatility, which has resulted in some market participants facing liquidity shortfalls. However, most international banks have only minor links to the Russian and Ukrainian financial systems, and so direct losses from these exposures do not pose a significant risk to these institutions or the global financial system. Nevertheless, the large falls in Russian asset values have meant losses for some investors, with some essentially writing off the value of their Russian investments.

Since late 2021, long-term interest rates have increased significantly following higher-than-expected inflation in many countries. Expectations of future increases in policy interest rates have also been brought forward. As a result, the prices of some financial assets have declined, although there have not been widespread falls in residential or commercial property prices.

With inflation higher and more persistent than forecast, there is a risk that short- and long-term interest rates could increase by more than financial markets currently expect. It is possible that the current disruptions to supply chains persist, prolonging the period of higher inflation and contributing to a shift up in inflation expectations. If so, policy interest rates in major economies might need to move higher than the currently expected peaks, which are low relative to the peaks in interest rates over recent decades.

In Australia, the financial system has remained highly resilient and supportive of the economic recovery. The banks remain very well capitalised, have high holdings of liquid assets and have ready access to wholesale funding. Loan arrears rates are low and have declined a little recently. Businesses and household balance sheets are in generally good shape, with many households having built up substantial buffers on their mortgages. Even so, housing credit growth has for some time exceeded growth in incomes, with the ratio of housing credit to income edging up from an already high level.

Key risks to financial systems

1. Highly indebted borrowers could struggle with rising interest rates and expenses

In many countries, debt-to-income ratios are at high levels in the household and business sectors. Higher interest rates will increase borrowers' debt payments, while high inflation will reduce the funds households and some businesses have available to make those payments, particularly if incomes stagnate. Loan performance could then deteriorate significantly. The risks of high indebtedness have been highlighted by the significant worsening in the financial health of property developers in China where efforts to reduce leverage risk a disorderly unwinding. A rise in global interest rates could trigger sharp capital outflows in emerging market economies, particularly those with weaker economic fundamentals and significant foreign currency debt.

The high level of household debt relative to income in Australia has increased the sensitivity of households and their spending to higher interest rates and a rise in living expenses. While banks have generally maintained strong lending standards, a large share of new housing loans have been written with high debt-to-income ratios. With interest rates still at historically low levels, it is important that lending standards are maintained and that borrowers are prepared for an increase in interest rates.

2. Many asset prices remain high but could fall with increases in interest rates or risk aversion

Globally, asset prices generally remain high and there is ongoing risk that a disruptive adjustment will occur. This could be triggered by larger-than-expected increases in interest rates, an increase in risk aversion due to global developments, dislocation in financial markets or weak income growth. Where assets are highly leveraged – in particular, residential and commercial property – large price falls could lead to significant losses for financial institutions, disrupting the functioning of financial systems.

3. Cyber-attacks continue to pose risks to financial systems and institutions

Cyber-attacks have become more frequent and more sophisticated in recent years and it is highly probable that at some point in time the defences of a significant financial institution will be breached. This would not only create problems for the institution concerned but could also undermine confidence in the broader financial system. It therefore remains critical that financial institutions and infrastructures have high resilience with the ability to quickly recover from a significant attack.