

Press release

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ECB review sees elevated financial stability risks due to uneven impact of pandemic

- Uneven economic impact of pandemic implies risks concentrated in specific sectors and countries
- Banks' asset quality holding up, but profitability weak and potential for credit risk to worsen
- Disorderly corrections in financial market segments may affect non-banks that have large exposures to corporates with weak fundamentals

The uneven economic impact of the pandemic means that financial stability risks are concentrated in specific sectors and countries, often with higher pre-existing vulnerabilities, concludes the May 2021 Financial Stability Review (FSR) of the European Central Bank (ECB).

“As the euro area emerges from the third wave of the pandemic, risks to financial stability remain elevated and have become more unevenly distributed. A higher corporate debt burden in countries with larger services sectors could increase pressure on governments and banks in these countries,” said Luis de Guindos, Vice-President of the ECB. “Extensive policy support, particularly for corporates, could gradually move from being broad-based to more targeted,” he added.

Policy measures helped corporate insolvencies to fall to historic lows during the pandemic . However, as this support is gradually removed, considerably higher insolvency rates than before the pandemic cannot be ruled out, especially in certain euro area countries. This in turn could weigh on sovereigns and banks which provided support to corporates during the pandemic.

In parallel, the last six months have seen continued rallies in many financial markets and higher prices in euro area residential real estate markets, increasing worries about overvaluation and the potential for abrupt asset price corrections. Recent increases in US benchmark yields have revived concerns about the potential for shifts in financial conditions. This could affect indebted corporates, households,

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sovereigns and those investors that have become increasingly exposed to duration, credit and liquidity risk in recent years.

Market sentiment towards banks has substantially improved, as reflected by a marked rise in bank stock prices since the trough last October. However, bank profitability remains weak, while prospects for lending demand are uncertain. Bank asset quality has been preserved so far, but credit risk may materialise with a lag, implying a need for increased loan loss provisions. Effective NPL solutions and full use of available capital buffers are needed to support the recovery.

Non-banks continue to have large exposures to corporates with weak fundamentals and are sensitive to a yield shock given their material bond portfolio duration, exposure to US markets and high degree of liquidity risk.

This edition of the FSR also includes new analysis about the impact of climate change on financial stability in the euro area. A significant share of bank loan exposures to corporates could be subject to a high level of climate-related physical risk, directly affecting firms' operations or the physical collateral used to secure loans. Both the assessment of risks and the allocation of financing to support the transition to a greener economy can benefit from enhanced disclosures and data, as well as clearer green finance standards. [Preliminary results from climate stress testing](#) indicate clear benefits from acting early.

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