EUROPEAN CENTRAL BANK

EUROSYSTEM

Press release

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Russia-Ukraine war increases financial stability risks, ECB Financial Stability Review finds

- Impact of war on energy prices, inflation and growth amplifies existing vulnerabilities
- Market reaction to invasion largely orderly, but risk of further correction remains
- Banks face weaker profitability after strong recovery in 2021

Financial stability conditions in the euro area have worsened as the Russian invasion of Ukraine leads to higher energy and commodity prices and increases risks to euro area inflation and growth, the May 2022 Financial Stability Review (FSR) published today by the European Central Bank (ECB) concludes.

“The terrible war in Ukraine has brought immense human suffering,” ECB Vice-President Luis de Guindos said. “It has also increased financial stability risks through its impact on virtually all aspects of economic activity and financing conditions.”

The market reaction to the Russian invasion of Ukraine has been largely orderly. However, prices for commodities and energy have remained elevated and volatile, which has caused some stress in derivatives markets for these products. Despite recent adjustments, some assets remain at risk of further corrections should the growth outlook weaken further and/or inflation turn out to be significantly higher than expected.

Vulnerabilities may increase due to the uncertain path of the Russia-Ukraine war and shifting expectations of policy normalisation in advanced economies. Other potential global developments, such as a broader resurgence of the coronavirus (COVID-19) pandemic, weaknesses in key emerging market economies or a sharper slowdown in Chinese economic activity, could also affect risks to growth and inflation.

Euro area non-financial corporations face challenges from rising input prices and a more clouded economic outlook. This may increase corporate defaults, especially for firms and sectors that have not

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yet fully recovered from the pandemic. Moreover, highly indebted firms and those with lower credit ratings may struggle with tighter financing conditions.

Euro area house prices have continued rising and mortgage lending growth has been accelerating, although a widespread extension of fixed-rate mortgages should shield many borrowers from higher interest rates in the near term.

The profitability prospects for European banks have weakened again, following a strong recovery in 2021. The potential impact of increased energy prices, higher inflation and weaker growth could cause asset quality risks to materialise. At the same time, only a few banks have significant direct exposure to Russia and Ukraine, and a recent vulnerability analysis carried out by the ECB indicates that the euro area banking system should remain resilient even under severely adverse economic scenarios.

Significant flows have taken place from investment funds that manage corporate bond portfolios to funds that manage sovereign bond exposures, as well as from growth to value equity funds. So far, these shifts have not been systemically disruptive, but the sector remains vulnerable due to its low liquidity, high duration risk and high exposure to bonds issued by weak corporates. Some funds also face additional risks from excessive leverage in derivatives or from investments in crypto-assets.

The resilience of the financial system would benefit from a more effective capital buffer framework. As recently proposed by the ECB, higher buffers that can be released in periods of stress would improve the ability of banks to absorb losses and maintain lending. Regulation to address risks in the non-bank financial sector, stemming for example from liquidity mismatches, leverage or margining practices, also needs to be strengthened.

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