EUROPEAN CENTRAL BANK

EUROSYSTEM

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Financial stability vulnerabilities remain elevated as geoeconomic shock unfolds

- Middle East war unleashes major supply shock, with highly uncertain outcomes
- Prolonged geopolitical stress and lingering fiscal challenges could test financial market sentiment
- Vulnerabilities among non-banks, including those active in private markets, could amplify stress in financial markets
- Exposures to non-banks and trade- and energy-sensitive firms constitute sources of credit, liquidity and funding risks for euro area banks

The outlook for euro area financial stability is being shaped by geoeconomic stress and energy supply disruptions, with the severity and duration of the fallout still uncertain, according to the May 2026 Financial Stability Review, which is published today by the European Central Bank (ECB).

“The current energy supply shock poses upside risks to inflation and downside risks to economic growth,” said ECB Vice-President Luis de Guindos. “It could also increase market volatility and challenge debt servicing capacities as financing costs rise in an environment of weaker economic growth.”

The global financial system and real economy had been remarkably resilient going into 2026, despite a series of shocks. This resilience is now being tested, though, by a major geoeconomic shock triggered by the war in the Middle East. Acute geoeconomic stress is being amplified by lingering uncertainty about global trade and international cooperation. Also, cybersecurity risks and hybrid threats to critical infrastructure are rising in this complex geopolitical environment.

Financial markets are adjusting to geoeconomic stress and energy supply disruptions. Initial financial market adjustments proved short-lived, however, leaving equity valuations still stretched by historical standards. At the same time, corporate bond risk premia have remained compressed globally, so that pricing is vulnerable to the unusually high level of geopolitical and policy uncertainty. There is therefore a fair risk that financial market sentiment could deteriorate, as downside risks related to

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geopolitical, fiscal and macro-financial developments appear underestimated. Fiscal expansion in a challenging geoeconomic environment could strain public finances further in some highly indebted euro area countries and lead to a repricing of sovereign risk.

Non-banks have remained largely resilient to the war in the Middle East but face risks from broad-based market downturns. In particular, the combination of low liquidity buffers, high portfolio valuations and concentrated exposures on their balance sheets raises the risk of forced asset sales that could amplify market stress. While not a systemic concern per se in the euro area, opaque and interconnected private markets warrant close monitoring owing to spillover risks, especially from the United States.

Euro area banks have navigated recent bouts of uncertainty well, buoyed by strong profitability and ample capital and liquidity buffers. The importance of non-bank sources in their funding mix could, however, expose them to liquidity and funding risks if market conditions were to become volatile. Added to this, the quality of banks' assets could deteriorate if macro-financial conditions were to worsen markedly as a result of the war in the Middle East, although their direct exposures to the region are limited and concentrated among a few banks. In particular, a prolonged shock could result in material second-round effects, especially for euro area firms operating in sectors that are simultaneously trade-, energy- and interest rate-sensitive, with possible knock-on effects for households via deteriorating labour market conditions or cost-of-living pressures.

In the current highly uncertain geoeconomic environment, preserving and strengthening the resilience of the financial system is key. To this end, macroprudential authorities should maintain existing capital buffer requirements and borrower-based measures to preserve bank resilience and ensure sound lending standards. In addition, persistent liquidity and leverage vulnerabilities in the non-bank financial intermediation sector call for a comprehensive policy response. Finally, accelerating progress on the EU's savings and investments union will be essential to support growth and competitiveness while safeguarding financial stability.

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