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EUROSYSTEM

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ECB review sees increased medium-term vulnerabilities for corporates and banks

- Dispersed economic and financial market impact on countries and sectors could lead to concentration of risks in some areas
- Policy measures have addressed liquidity challenges but risks can arise from premature or delayed withdrawal of fiscal support
- Bank profitability prospects remain weak with losses potentially materialising with a lag relative to the recovery

Vulnerabilities in the corporate sector are increasing as the pandemic evolves and their unearthing could test the resilience of euro area banks in the future, the European Central Bank (ECB) says in its latest Financial Stability Review (FSR). Current extensive policy support is helping euro area corporates and households to cope with the fallout of the pandemic, but risks can arise either from a premature end to measures or from prolonged support. Premature withdrawal of fiscal support – including government loan guarantees and statutory loan moratoria – could set back the economic recovery, transforming the corporate liquidity challenges observed at the outset of the pandemic turn into solvency issues. The sharp rise in corporate and sovereign indebtedness increases the risks to financial stability from an emerging sovereign-corporate bank nexus in the medium-term, as banks and sovereigns alike are exposed to pandemic-induced risk faced by euro area firms.

“Bank profitability is expected to remain weak. Provisions have increased but look optimistic in some cases, while guarantees and moratoria may have lengthened the time it takes for weak economic performance to translate into loan losses,” said Luis de Guindos, Vice-President of the ECB. “Government support schemes are essential currently but should remain targeted towards pandemic-related economic support and avoid giving rise to debt sustainability concerns in the medium term,” he added.

For euro area banks, which entered the pandemic with stronger balance sheets than at the time of the global financial crisis, a premature end of government guarantees and moratoria could lead to an additional wave of losses. They are also expected to face continued pressures on profitability, including from a weaker outlook for lending and continued structural challenges. Banks' capital buffers remain comfortable and should remain available to absorb losses and support lending for an extended period. Authorities need to monitor the effectiveness of policies to support buffer use and avert deleveraging. Looking beyond the pandemic, it is important for banks, together with the rest of the financial system, to manage the financial stability risks posed by climate change and support the transition to a greener economy.

A return to risk-taking by non-banks, including investment funds, also increases their vulnerability to outflows and losses should corporate credit risks rise materially. These risks are accentuated by continued gaps in the macroprudential framework for non-bank financial institutions.

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Notes

- The FSR is the ECB's semi-annual publication mapping the sources of risk and vulnerabilities for the euro area financial system as a whole. If you want to find out more about how the pandemic compares to previous crises in terms of financial stability risks and dig deeper in how households and corporates were affected so far listen to the most recent ECB podcast.

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