



ESRB

European Systemic Risk Board

European System of Financial Supervision

Press release

30 June 2022

The General Board of the European Systemic Risk Board held its 46th regular meeting on 23 June 2022

At its meeting on 23 June 2022, the General Board of the European Systemic Risk Board (ESRB) concluded that risks to financial stability have increased perceptibly since its last meeting. The General Board took note of the significant deterioration in global economic growth prospects owing to the sharp increase in energy, food and commodity prices, which has been compounded by the Russian invasion of Ukraine and renewed supply chain disruptions. Moreover, the normalisation of monetary policy is leading to a rise in the cost of financing which may weigh on debt servicing capacity. The General Board emphasised that the combination of these developments and their possible mutual amplification have heightened uncertainty and the probability that tail risk scenarios may materialise.

The materialisation of tail risk scenarios would increase the risk of renewed balance sheet stress for firms and households. This risk is particularly high for sectors that are very sensitive to energy and commodity prices or are still struggling with the aftermath of the coronavirus (COVID-19) pandemic on account of turnover losses and increased indebtedness. In addition, tighter financing conditions will particularly affect the debt servicing capacity of lower-rated firms and firms availing themselves of loans with variable interest rates.

Renewed balance sheet stress in the corporate sector would also weigh on the outlook for asset quality and profitability in the EU banking sector. The members of the General Board noted that the impact of the war in Ukraine on the EU banking sector has so far been well contained, reflecting generally low direct exposures to Russia, robust capital positions and the recovery in bank profitability to pre-pandemic levels. However, they raised concerns about a possible broad-based impact of the war on economic growth and, concomitantly, credit risk at a time when some banks are still in the process of working out pandemic-related asset quality issues. In this context, they

considered it essential to ensure that banks' provisioning practices properly reflect the rise in credit risk stemming from the direct and indirect impacts of the Russian invasion of Ukraine. They also pointed to the uncertain profitability outlook for the banking sector, noting that the positive impact of rising nominal interest rates on net interest income could be offset by lower demand for credit and new impairments, as well as by the low interest income on portfolios of fixed interest mortgages at low rates.

The General Board noted that – notwithstanding recent corrections – the risk of an abrupt and broad-based fall in asset prices remains a severe risk to financial stability. Rising interest rates in combination with deteriorating growth prospects have led to a decline in asset prices that has been orderly thus far. However, current equity valuations reflect optimistic assumptions that the impact of the war on global growth prospects will be contained overall and that central banks will be able to gradually reduce inflation rates to their objectives over the medium term, as currently expected by markets. The materialisation of tail risk scenarios could therefore pose a risk of further broad-based and possibly abrupt asset price corrections.

The aforementioned disorderly market corrections could lead to losses, substantial redemption requests and liquidity strains for some investment funds. In addition, some investment funds are also exposed to the risks of excessive leverage and interconnectedness, which might exacerbate shocks to financial stability. Furthermore, liquidity and credit risks are rising as bond funds increase their holdings of lower-rated and less liquid fixed income securities. These concerns will be summarised in the seventh edition of the EU Non-Bank Financial Intermediation Risk Monitor, which will be published in July.

The General Board also discussed risks related to residential real estate markets. In several EU Member States, strong house price growth has coincided with a rapid expansion of mortgage lending, suggesting the possible emergence of a price-lending spiral. At the same time, the normalisation of monetary policy is resulting in a rise in bank lending rates, which can be expected to slow the demand for credit and house purchases. This rise can also be expected to weigh on households' debt servicing capacity, most notably if households are highly indebted or avail themselves of variable-rate mortgages. However, the current low levels of unemployment, together with the savings accumulated by households during the coronavirus crisis, should be considered a mitigating factor. This impact could be compounded by the erosion of real household income on account of prolonged high inflation. However, while these factors are raising the probability of a correction of residential real estate prices, demand for residential real estate may be bolstered by buyers who are considering purchasing property as a hedge against high inflation.

The General Board also exchanged views on the financial stability implications arising from crypto-based products and decentralised finance, and noted that, while potential systemic implications stemming from these market segments currently seem limited, systemic risks could materialise quickly and suddenly. The General Board concluded that if the rapid growth trends observed in recent years continue, crypto-based products will pose risks to financial stability.

Therefore, while reaffirming its support for a quick adoption and implementation of the Markets in Crypto-Assets Regulation, the General Board decided that the ESRB should focus its efforts on (i) considering the need for additional regulatory measures and identifying policy steps to address the potential threat to financial stability, as well as making proposals on how to ensure a European and global regulatory standard is developed; (ii) identifying systemic implications of the crypto-market for the EU financial system, including legal recourse considerations; and (iii) regularly monitoring financial market exposures to crypto-based products and decentralised finance. Given the pace at which crypto-market and decentralised finance applications are evolving and growing, the General Board deemed it necessary to conduct this work as a matter of urgency.

The General Board welcomed the third joint ECB/ESRB report on the financial stability implications of climate change. The report expands the risk metrics, enhances the scenario analysis and outlines initial considerations for potential macroprudential tools. The report also confirms that climate-related financial risks are concentrated within certain financial institutions. Their evolution is dependent on a timely and orderly transition to a low-carbon economy. In this regard, the risks of a disorderly transition have increased given the pressures on energy prices resulting from the war in Ukraine. The General Board highlighted that microprudential and macroprudential policies should complement each other, with macroprudential policy focusing on risks that cut across sectors and countries. However, a broader set of policies beyond merely prudential ones is essential to tackle climate change adaptation and limit its impact. The publication of this report is foreseen for July. The General Board mandated the joint project team to continue its work on closing analytical gaps and deepening the analysis of macroprudential policy options.

Furthermore, in accordance with ESRB Regulation (EU) No 1092/2010, the General Board reappointed Pablo Hernández de Cos, Governor of the Banco de España, as Chair of the Advisory Technical Committee.

Finally, the ESRB has today released the 40th issue of its risk dashboard. The ESRB's risk dashboard is a set of quantitative and qualitative indicators measuring systemic risk in the EU financial system.

For media queries, please contact William Lelieveldt, tel.: +49 69 1344 7316.