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COVID-19 pandemic: financial stability implications for the EU financial sector

Following the onset of the COVID-19 pandemic, EU bodies, national governments, central banks, and supervisory and resolution authorities took unprecedented action to support the economy. Responding to the initial shock in financial markets, the ESRB General Board identified and took measures in five priority areas: (i) the implications for the financial system of guarantee schemes and other fiscal measures to protect the real economy; (ii) market illiquidity and its implications for asset managers and insurers; (iii) the impact of procyclical downgrades of bonds on markets and entities across the financial system; (iv) system-wide restraints on dividend payments, share buybacks and other payouts; and (v) liquidity risks arising from margin calls. Beyond the immediate financial market volatility in March and April 2020, significant challenges remain. In June 2020 the ESRB reviewed its systemic risk assessment to account for recent developments. A key systemic risk stems from the widespread defaults in the real economy which are expected in light of a deep global recession. This is likely to result in a challenging macroeconomic environment for both banks and non-banks.

The European Central Bank (ECB) completed its vulnerability analysis of banks to assess the sector's resilience to stress caused by the Covid-19 pandemic. As the planned EU-wide stress test exercise was cancelled due to the pandemic, the ECB's top down analysis provides a best estimate of the sector's resilience. The assessment includes a severe stress scenario where real GDP falls by 12.6% in 2020 which would deplete banks' average CET1 from 14.5% to 8.8%. Key drivers for the modelled fall in capital are impaired credit exposures, market risk losses and lower profitability. Several banks would need to take action to maintain compliance with their minimum capital requirements, but the overall shortfall would remain contained. The high level of resilience in banks is a reflection of the regulatory reforms since the 2008 global financial crisis as banks are facing the current crisis with significantly higher capital levels. With bank profitability strained in recent years, those banks that have previously strengthened their profitability through efficiency-enhancing measures tend to be better positioned to withstand a severe stress. When entering the next phase of the crisis, it will remain important for banks to deploy their capital effectively. With its recommendation, the ESRB is supportive of financial institutions (banks, insurance corporations and CCPs) choosing to preserve their capital resources through dividend restrictions in these critical times, until end January 2021. This can help to enhance the resilience of the financial sector, strengthen its capacity to lend to the real economy as the crisis unfolds and reduce the risk of failure of financial institutions.

Risks also remain elevated for the non-bank sector where a deterioration of liquidity in financial markets can pose significant challenges. The ESRB took several measures at the onset of the crisis to help address risks faced by investment funds and insurers stemming from market illiquidity. This included a statement highlighting the importance of the timely use of liquidity management tools by investment funds, a Recommendation to ESMA to undertake a focused supervisory exercise to assess vulnerabilities in some segments of the investment fund sector, and a communication to EIOPA supporting increased monitoring of liquidity risk in insurers. Given the expected rise of defaults in the real economy, the mechanistic reliance on credit ratings by some institutions could pose a risk to financial stability. The ESRB therefore conducted a system-wide scenario analysis to help assess future possible fire sales which could be triggered by widespread simultaneous bond downgrades.

While the current focus particularly remains on responding to the immediate crisis, the ESRB also highlights three additional systemic risks which require continued monitoring. These include operational risks such as a system-wide cyber incident, finance-driven disruptions in critical financial infrastructure, and risks linked to climate change. Given the large potential impact of some of these risks, continued progress to tackle them will remain important while navigating the current crisis. ●