Luis de Guindos: Financial stability in the euro area

Speech by Mr Luis de Guindos, Vice-President of the European Central Bank, at the Frankfurt Euro Finance Week, organised by the *dfv* Euro Finance Group, Frankfurt am Main, 18 November 2024.

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It is my great pleasure to continue the tradition of joining you at the Frankfurt Euro Finance Week. In today's remarks I will provide you with our latest assessment of the risks to financial stability in the euro area, which we will soon publish in more detail in the ECB's Financial Stability Review – a publication that celebrates its twentieth anniversary this week. I will then discuss the resilience of euro area banks and non-banks. And finally, with Europe at the crossroads, I will emphasise the importance of strengthening financial integration, completing banking union and moving forward on the capital markets union.

Volatile and uncertain macro-financial outlook

If you look at where we are now compared with a year ago, the balance of macro-risks has shifted from concerns about high inflation to fears over economic growth. Consumer price inflation has moved closer to our 2% target. But economic activity has been weaker than expected: we have revised down our projections twice – before the summer and in September. The growth outlook is clouded by uncertainty about economic policies and the geopolitical landscape, both in the euro area and globally. Trade tensions could rise further, increasing the risk of tail events materialising. These cyclical headwinds compound structural issues of low productivity and weak potential euro area growth.

Against a background of heightened uncertainty, our upcoming Financial Stability Review highlights three main vulnerabilities that shape the euro area outlook.

Key financial stability vulnerabilities

The first vulnerability relates to financial markets, which remain susceptible to sudden, sharp adjustments. While recent high-volatility episodes were short-lived and had only limited impact on the financial system, underlying vulnerabilities make financial markets prone to bouts of volatility in the future. First, record-low equity premia and compressed corporate bond spreads are signs that investors may be underestimating the likelihood and potential impact of adverse scenarios. Second, concentration of equity market capitalisation and earnings among a handful of companies, notably in the United States, has increased greatly in recent years, raising concerns over the possibility of an asset price bubble connected to artificial intelligence. Given how deeply integrated global equity markets are, negative firm-specific or sector-specific surprises could easily spill-over across the borders.

The second vulnerability relates to rising sovereign risks. While the aggregate euro area debt-to-GDP ratio has declined considerably from its peak during the pandemic, debt levels remain high in many countries owing to persistent primary deficits. Under these circumstances, fiscal slippage or questions around fiscal consolidation paths could trigger further repricing of sovereign risk. Current large primary deficits will also make it harder for governments to support the economy if adverse shocks materialise, and they will make it more difficult to provide additional investment to cope with structural challenges, including climate change, defence spending, digitalisation and low productivity. This in turn could give rise to a negative feedback loop between low growth and sovereign debt sustainability.

The third vulnerability relates to credit risk. Amid weak growth prospects, credit risk remains a concern for some euro area firms and households and could affect asset quality of banks and non-banks. Overall, firms and households have weathered the impact of past interest rate increases and appear resilient generally. Nevertheless high – albeit declining – lending rates remain a challenge for some borrowers. Insolvencies – a lagged indicator of corporate financial health – have been rising across sectors and countries, although from relatively low levels. The debt servicing capacity of small and medium-sized enterprises and of commercial real estate firms appears to be particularly vulnerable to a slowdown in economic activity and higher borrowing costs. At the same time, the euro area commercial real estate markets show signs of stabilisation, with investor demand slowly recovering, in line with less restrictive monetary policy. In addition, higher interest rates continue to challenge households with lower incomes and floating-rate mortgages. Slower growth and a weakening labour market could further undermine the debt servicing capacity of these borrowers.

Financial sector's resilience

The previous point in particular raises the question: are euro area financial institutions well prepared to cope with these risks?

Here the good news is that bank balance sheets are strong, making it easier for banks to absorb losses, if asset quality deterioration were to accelerate. Lower operating expenses and strong net interest margins have enabled euro area banks to maintain high levels of profitability. Banking sector resilience is bolstered by solid capital ratios and liquidity buffers, despite the gradual phasing-out of funding from targeted longer-term refinancing operations. That being said, bank profitability may have peaked, with earnings on floating-rate assets becoming a headwind for interest income and credit losses starting to rise.

Turning to the non-bank financial intermediation (NBFI) sector, non-banks remain vulnerable to, and could amplify, macroeconomic and financial market shocks. A significant proportion of non-banks' holdings – especially of corporate bonds and equities – are from issuers in countries projected to experience low economic growth and high levels of sovereign debt. Consequently, any potential downturn could weigh on asset quality in NBFI portfolios. Additionally, the rising exposure of the NBFI sector to global markets, including US-based technology firms, makes non-banks vulnerable to shocks and volatility in those markets. This could expose the sector to sudden sharp declines in asset values and returns, putting further strain on their resilience.

Some segments of the NBFI sector also face structural vulnerabilities related to liquidity mismatches and high leverage. These issues make the sector more susceptible to amplifying shocks through forced asset sales. When asset values or returns decline sharply, open-ended investment funds – such as real estate funds – may be forced to sell assets to meet redemption demands. This risk is heightened in sectors like commercial real estate, as in some euro area countries a potential fall in property prices has not yet been fully reflected in fund valuations. This implies that the risk of price corrections and subsequent outflows remains elevated.

Furthermore, pockets of high financial and synthetic leverage in the investment fund sector – most notably in hedge funds – introduces another layer of vulnerability. As we have seen in previous crises, leverage can magnify losses, making the sector more prone to systemic risks in times of market stress.

Safeguarding resilience and strengthening financial integration

Looking at the current highly uncertain geopolitical and economic environment, regulatory standards remain key to preserve the resilience of banks and non-banks' alike. Existing macroprudential capital buffer requirements for banks as well as borrower-based measures should be maintained. In this context, it is reassuring that the final elements of Basel III were implemented in EU law in June 2024.

While sound capital and liquidity buffers are the first line of defence against bank failures, they must be complemented by steady and agile supervision in a full banking union. Our work on this front is not yet done. To complete the banking union, we must address key gaps in our institutional framework. This includes finalising the crisis management toolkit for EU large banks and making progress in other areas, such as liquidity in resolution and a backstop to the Single Resolution Fund. A critical gap that demands attention is the absence of a European deposit insurance scheme.[1] Progress towards a full banking union that would remove barriers to greater financial system integration across euro area countries remains a priority if we want to make our banking system more efficient.

It is also essential to strengthen the resilience of the NBFI sector, not only to protect individual institutions but also to safeguard the broader stability of the financial system, especially since a more resilient non-bank sector will reduce the likelihood of spillovers to the banking sector.[2] A sound NBFI sector is also a prerequisite for achieving deeper financial integration in the euro area and completing of the capital markets union.

Progress on the capital markets union should be central to a revised strategy to enhance Europe's productivity and economic growth. Greater economic integration goes hand-in-hand with greater financial integration. By mobilising capital markets more effectively, we can deepen the Single Market and provide much-needed financing to innovative and productive firms across Europe. This is crucial for supporting long-term growth and securing the financing of the green transition.

However, achieving these objectives will not be without its challenges. The ambition to strengthen capital markets must be accompanied by concrete policies. A more prominent role for the non-bank financial sector should go along with a robust macroprudential framework to ensure its resilience. The European Commission's consultation on macroprudential policies for NBFI is an important step toward addressing the risks in this industry.

Let me conclude with a clear message on the financial sector. Now is not the time to roll back hard- won regulatory progress. With sources of risk and vulnerability remaining elevated against a background of great uncertainty and weak growth prospects, our current moment is one for upholding regulation, preserving resilience and pressing ahead with macroprudential policies for non-banks. A stronger and stable financial system with developed capital markets can be a vital engine of growth for Europe in the years ahead.

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[1] See de Guindos, L., (2023), "Banking Union and Capital Markets Union: high time to move on", speech at the Annual Joint Conference of the European Commission and the European Central Bank on European Financial Integration, Brussels, 7 June.

[2] See Franceschi, E. et. al., (2023), "Key linkages between banks and the non-bank financial sector", *Financial Stability Review*, ECB, May.