

# Press release

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## Pandemic increases risks to financial stability

- Pandemic greatly amplified existing vulnerabilities of the financial sector, corporates and sovereigns
- Policy responses to pandemic essential to preserve financial stability
- Euro area banks, although now better capitalised, likely to face significant losses and further pressure on profitability

Despite the immense social and economic disruption in the wake of the coronavirus (COVID-19) pandemic, decisive policy responses have helped to prevent a seizing-up of the financial system. However, even as infection rates fall in many countries, the impact on the economy and markets has unearthed and increased existing vulnerabilities for euro area financial stability, according to the May 2020 Financial Stability Review (FSR) of the European Central Bank (ECB). Financial stability risks could arise as these vulnerabilities, [identified in earlier issues](#), interact with the pandemic. These include richly valued asset prices, fragile investment funds, the sustainability of sovereign and corporate debt, and weak bank profitability.

“The pandemic has caused one of the sharpest economic contractions in recent history, but wide-ranging policy measures have averted a financial meltdown”, ECB Vice-President Luis de Guindos said. “However, the repercussions of the pandemic on bank profitability prospects and medium-term public finances will need to be addressed so that our financial system can continue to support the economic recovery”, he added.

As the virus spread globally in late February, financial markets saw dramatic falls in asset prices, sharp increases in volatility, illiquidity in some core markets and a general tightening of financial conditions. Some market reactions were amplified by the need for investment funds to sell assets to meet large outflows. Action by central banks globally, notably the ECB’s announcements of large-scale asset purchases (under the public sector purchase programme and the pandemic emergency purchase programme), helped stabilise conditions in markets.

### European Central Bank

Directorate General Communications, Global Media Relations Division  
Sonnemannstrasse 20, 60314 Frankfurt am Main, Germany  
Tel.: +49 69 1344 7455, e-mail: [media@ecb.europa.eu](mailto:media@ecb.europa.eu), website: [www.ecb.europa.eu](http://www.ecb.europa.eu)

All euro area countries announced fiscal packages to cushion the economic ramifications of the crisis for households and companies. These fiscal measures should support the economic recovery. In particular, they could help the many corporates which are now facing cash-flow strains. Some riskier firms, which had levered up in recent years, are likely to face additional challenges. Looking ahead, the associated increase in public debt levels could also trigger a reassessment of sovereign risk by market participants and reignite pressures on more vulnerable sovereigns.

Although supported by a significant increase in capital and liquidity since the global financial crisis, bank valuations fell to record lows and funding costs increased. This reflected both the deterioration in economic prospects and considerably higher uncertainty about the outlook for euro area banks' profits and asset quality. Mirroring changes in corporate earnings expectations and weaker income generation on new business, the return on equity for euro area banks in 2020 is now expected to be significantly lower than it was before the pandemic.

Banks should benefit from the action of prudential authorities across the euro area to ease capital requirements and grant banks more operational flexibility to maintain the flow of credit to the economy. In addition, ECB Banking Supervision recommended that banks temporarily refrain from paying dividends or buying back shares, strengthening their capacity to absorb losses and avoid deleveraging. These capital measures are expected to remain in place until the economic recovery is well established.

This issue of the FSR also contains a number of boxes and special features touching on aspects of both recent developments and other important vulnerabilities, including on the potential impact of government loan guarantee schemes (Box 4), bank dividend payout suspensions (Box 5), bank and non-bank interlinkages (Box 6), and the macroeconomic impact of financial policy measures (Box 8).

**For media queries, please contact [Eszter Miltényi-Torstensson](mailto:Eszter.Miltényi-Torstensson@ecb.europa.eu), tel.: +49 69 1344 8034.**