Luis de Guindos: Financial stability in the euro area

Speech by Mr Luis de Guindos, Vice-President of the European Central Bank, at the International Swaps and Derivatives Association (ISDA) Annual General Meeting, Amsterdam, 15 May 2025.

* * *

Introduction

Recent months have been rather eventful on global financial markets, bringing to the fore discussions about risks to financial stability and the resilience of financial institutions. I would like to explore these topics in more detail today, with a particular focus on the euro area.

A volatile and uncertain macro-financial outlook

Faced with the reality that globalisation as we know it has come to an end, the world is adjusting to a new environment. As our economic and financial systems adapt, greater geoeconomic fragmentation globally may increase the likelihood of more frequent and more impactful adverse tail events. The most immediate concern is that ongoing trade tensions could escalate into a trade war, with potentially significant negative consequences for global growth, inflation and asset prices.

As the euro area economy is very open and deeply integrated into global supply chains, there are a number of financial stability vulnerabilities that could be tested. But the elevated level of uncertainty has not been limited to trade. Several other policy areas, including monetary, fiscal and national security policies, have also been affected.

Key financial stability vulnerabilities

We see three key vulnerabilities in the ECB Financial Stability Review to be published next week. The first concerns financial markets. A considerable increase in US trade policy uncertainty to more than 60 times the historical average has injected significant volatility into financial markets. Trade policy uncertainty can also lead to greater exchange rate volatility, affecting portfolio investment decisions and capital flows. Equity markets remain particularly vulnerable to sudden, sharp adjustments owing to persistently high valuations and risk concentration. We have warned of vulnerabilities posed by high valuations that are not backed by fundamentals, and recent financial market volatility has shone a light on this source of risk. Notably, the CBOE Volatility Index (VIX), jumped to three times its historical average following the announcement of US import tariffs on 2 April. As the considerable declines in the aftermath of that announcement have largely been recouped, equity valuations – especially in the United States – remain elevated.

We also continue to see strong geographical and sectoral market concentrations. While the United States accounts for around 4% of the world's population and around a quarter of global GDP, its equity market accounts for more than two-thirds of global equity market capitalisation according to the MSCI global index. Moreover, just a handful of large US-based technology companies account for 30% of S&P 500 market capitalisation. Like with equity market risk premia, credit spreads remain compressed and appear to be out of sync with the very high levels of geopolitical and policy uncertainty. As such, there is a risk that investors may be underestimating and underpricing the likelihood and impact of adverse scenarios. Negative surprises in a volatile and uncertain environment – including sharply deteriorating economic growth prospects, sudden changes in monetary policy expectations or an escalation of trade tensions – could lead to further abrupt shifts in investor sentiment, causing spillovers across different asset classes while fuelling investors' interest in alternatives such as gold and crypto-assets, as we have recently seen.

The second vulnerability relates to the euro area economy. Escalating trade tensions could affect euro area firms and households, with potential credit risks for both banks and non-banks. On aggregate, the balance sheet fundamentals of euro area firms and households have improved in recent years, with their levels of indebtedness falling below those seen before the pandemic. However, trade tensions, high funding costs and weak growth could be a sign of headwinds in the near future. And even if trade tensions subside, this period of high uncertainty is very likely to have led to precautionary actions by firms and households, which could act as a drag on growth. In addition to increased foreign competition, rising global trade tensions could exacerbate credit risk in the corporate sector, with a negative impact on the profitability of firms operating in highly export-oriented and tariff-sensitive sectors, such as the steel industry or the automotive sector. Households continue to benefit from stable labour markets, rising real wages and higher savings. But this situation could reverse if trade-related corporate vulnerabilities unravel and lay-offs in the corporate sector rise, which could have an adverse impact on employment and consumption.

The third vulnerability is related to sovereign risks. The public debt-to-GDP ratio in the euro area has fallen since the pandemic but the fiscal positions of some euro area countries remain weak. And looking ahead, although higher defence spending and substantial infrastructure investments are warranted in light of current geoeconomic challenges, they are likely to lead to a deterioration in fiscal balances.

These expectations have led markets to price in higher government financing needs which, together with the expectation that additional spending could have a positive impact on growth, contributed to the recent rise in ten-year euro area government bond yields. This rise has since partly reversed as a result of "flight to safety" inflows to euro area government bond markets following the announcements of US tariffs. Nevertheless, an increase in debt servicing costs could put a further strain on fiscal positions, especially in countries which have high short-term refinancing needs and are already burdened by high debt levels. Moreover, the risks to growth resulting from trade tensions combined with higher defence spending may limit the fiscal space available to shield the economy from adverse shocks, address structural challenges associated with climate change, digitalisation and low productivity, and manage the economic implications of ageing populations.

Financial sector resilience

Given these vulnerabilities, we have to ask ourselves whether euro area financial institutions are sufficiently well prepared to cope with the associated risks.

Euro area banks are well capitalised, supported by solid profitability and robust asset quality. However, while non-performing loan ratios remain near historical lows, the credit risk outlook for corporate and household portfolios is expected to deteriorate given weak macro-financial conditions, the lagged impact of high interest rates on borrowers and escalating trade tensions. In particular, any broader and longer-lasting macro-financial effects of trade policy uncertainty could lead to a deterioration in banks' asset quality, especially for banks with higher exposures to sectors that rely on trade with countries outside the EU.

At the same time, lower net interest income poses downside risks to bank profitability, especially for banks with a higher share of floating rate loans and a higher cost of risk. The extremely uncertain external environment reinforces the need to keep macroprudential capital buffer requirements at levels that ensure the banking sector remains resilient. The regulatory and supervisory framework has effectively safeguarded financial stability while also supporting economic growth. Nevertheless, there is scope to make the framework more efficient and effective by reducing unwarranted complexities without compromising banks' resilience.

On a positive note, the recent high volatility has not impeded the functioning of financial markets. Overall, non-banks appear to have weathered the adverse market disturbances relatively well thus far. They have also continued to absorb a high share of sovereign debt, underscoring their important role in euro area sovereign bond markets in the context of higher debt issuance.

However, sharp adjustments could still become disorderly, especially if non-banks' low levels of liquidity amplify price swings. In an environment of heightened geopolitical and trade policy uncertainty, non-banks may face higher valuation losses and more frequent margin calls as trade tensions increase market volatility and weigh on asset quality. Significant exposures to US dollar-denominated assets may also increase the risk of additional spillovers from potential US market shocks and exchange rate fluctuations. In particular, structural liquidity mismatches in open-ended funds, exacerbated by escalating global trade disputes that heighten the risk of sudden outflows, could leave liquid asset holdings insufficient to cover severe yet plausible redemption shocks, thereby amplifying adverse market dynamics. Insurance corporations and pension funds could also face liquidity pressures as a result of increasing margin calls, as these entities make extensive use of interest rate derivatives for hedging purposes. At the same time, increasing synthetic leverage in some entities, like hedge funds, may exacerbate risks of financial contagion and expose liquidity vulnerabilities through margin calls.

These persistent liquidity and leverage vulnerabilities in the non-bank financial intermediation (NBFI) sector require a comprehensive policy response. The rising market footprint and interconnectedness of non-banks increases the risk that NBFI vulnerabilities amplify adverse market developments across the entire financial system. This is why we need an effective macroprudential policy framework for non-banks that improves the sector's resilience. The policy response should focus on addressing key structural vulnerabilities in the NBFI sector, including monitoring and tackling risks from non-bank leverage, enhancing the liquidity preparedness of non-banks to meet margin and collateral calls, and mitigating liquidity mismatches in the investment fund sector. Moreover, strengthening NBFI policies would help ensure that non-banks remain resilient under stress and thus bolster the capital markets union. It is vital that we establish comprehensive and resilient capital markets to reinforce the EU's Single Market, in addition to fostering economic and financial integration and ensuring that innovative companies have access to sufficient sources of financing. This cannot be achieved in isolation – it requires enhanced EU-wide supervisory coordination and improved global cooperation to level the playing field and minimise the potential for regulatory arbitrage.

Conclusion

All in all, financial stability in the euro area has remained sound throughout the market turbulence and major uncertainty. But despite broad resilience in both the financial and non-financial sectors, there is no room for complacency. Uncertainties arising from trade tensions, deregulation and reduced international cooperation are fuelling concerns about global economic and regulatory fragmentation. Rising trade tensions pose particular risks to the open euro area economy that is deeply integrated into global supply chains. In this highly uncertain and volatile environment, the likelihood of tail events remains high. Risk sentiment could deteriorate abruptly as still high valuations and increasing risk concentration render equity and credit markets vulnerable to shocks. While increased defence spending has the potential to boost growth if it is well targeted and sourced from within the EU, it may exacerbate fiscal vulnerabilities in some countries. And trade policy uncertainty could have an adverse impact on trade-reliant firms, with the associated broader economic repercussions translating into rising credit risk for banks and non-banks. Given this elevated and pervasive uncertainty, strong regulatory and supervisory frameworks remain key across all financial sectors to ensure that the resilience we have seen up to now also holds firm in the face of future risks.