ESAs warn of rising risks amid a deteriorating economic outlook

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The three European Supervisory Authorities (EBA, EIOPA and ESMA - ESAs) issued today their Autumn 2022 joint risk report. The report highlights that the deteriorating economic outlook, high inflation and rising energy prices have increased vulnerabilities across the financial sectors. The ESAs advise national supervisors, financial institutions and market participants to prepare for challenges ahead.

The post-pandemic economic recovery in Europe has dwindled as a result of the Russian invasion of Ukraine. Russia's war on Ukraine and the disruptions in trade caused a rapid deterioration of the economic outlook. It adds to pre-existing inflationary pressures by strongly raising energy- and commodity prices, exacerbates imbalances in supply and demand, and weakens the purchasing power of households. The risk of persistent inflation and stagflation has risen.

These factors, coupled with the deteriorated economic outlook, have significantly impacted the risk environment of the financial sector. Financial market volatility has increased across the board given high uncertainties. After a long period of low interest rates, central banks are tightening monetary policy. The combination of higher financing costs and lower economic output may put pressure on government, corporate and household debt refinancing while also negatively impacting the credit quality of financial institutions' loan portfolios. The reduction of real returns through higher inflation could lead investors to higher risk-taking at a time when rate rises are setting in motion a far-reaching rebalancing of portfolios.

Financial institutions also face increased operational challenges associated with heightened cyber risks and the implementation of sanctions against Russia. The financial system has to date been resilient despite the increasing political and economic uncertainty.

In light of the above risks and vulnerabilities, the Joint Committee of the ESAs advises national competent authorities, financial institutions and market participants to take the following policy actions:

Financial institutions and supervisors should continue to be prepared for a deterioration in asset quality in the financial sector and monitor developments including in assets that benefitted from temporary measures related to the pandemic and those that are particularly vulnerable to a deteriorating economic environment, to inflation as well as to high energy and commodity prices.

The impact of further increases in policy rates and of potential sudden increases in risk premia on financial institutions and market participants at large should be closely monitored.

Financial institutions and supervisors should closely monitor the impact of inflation risks.

Supervisors should continue to monitor risks to retail investors, in particular with regard to products where consumers may not fully realise the extent of the risks involved, such as crypto-assets.

Financial institutions and supervisors should continue to carefully manage environmental risks and cyber risks to address threats to information security and business continuity.

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