EUROPEAN CENTRAL BANK
EUROSYSTEM

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ECB and ESRB issue joint report analysing financial stability risks from linkages between banks and the non-bank financial intermediation sector

- Interconnections between EU banks and the non-bank financial intermediation (NBFI) sector can give rise to systemic risks
- Systemic risks stem from concentrated short-term funding from NBFI entities to banks and bank lending to leveraged NBFI entities
- Granular data are crucial to assess bank-NBFI linkages, but data gaps constrain analysis

The European Central Bank (ECB) and the European Systemic Risk Board (ESRB) today published a joint report entitled "Financial stability risks from linkages between banks and the non-bank financial intermediation sector". The report finds linkages between banks and the non-bank financial intermediation (NBFI) sector to be significant, and while they do not currently pose acute risks to financial stability, they create important vulnerabilities that could amplify stress in adverse market conditions. Furthermore, these vulnerabilities are highly concentrated in a small number of large euro area global systemically important banks (G-SIBs). Risk-bearing capacity among euro area G-SIBs is key to absorbing shocks in the financial system and preventing the amplification of financial stress.

The report identifies three important and interlinked roles played by banks in interactions with the NBFI sector: liquidity management, provision of leverage and market-making. It analyses how interactions between banks and NBFIs may affect financial stability in the EU.

These three roles may lead to the materialisation of systemic risks through two main channels.

- First, a loss of funding from NBFI entities could create challenges for banks in periods of market tension owing to the short-term nature of such funding, the homogeneity of NBFI funding providers and the limited scope for substitution. A negative and systemic price shock in asset

European Central Bank
Directorate General Communications
Sonnemannstrasse 20, 60314 Frankfurt am Main, Germany
Tel.: +49 69 1344 7455, email: media@ecb.europa.eu, website: www.ecb.europa.eu

markets could trigger redemption requests to NBFIs and margin calls on derivatives and repo trades. This, in turn, could potentially result in a broad-based decline in NBFI funding to banks.

- Second, lending to NBFI entities which use leverage indirectly exposes banks to the outcomes of NBFI trading strategies. Hedge funds and securities firms borrow from banks via repo transactions and use leverage for short-term trading. These linkages may increase vulnerability to asset price shocks, potentially leading to unwinding of positions and asset fire sales. Such dynamics could amplify market movements and generate losses for both banks and NBFI entities. Lending to leveraged NBFI entities which invest in illiquid long-term assets could be vulnerable to shocks affecting those assets, potentially leading to credit losses for banks.

The report provides novel insights based on granular transaction and exposure-level data. Such data are key to understanding bank-NBFI linkages, but the analysis is constrained by data gaps and fragmented data access. Notably, data on exposures outside the EU and transactions taking place outside the EU are largely missing, reducing the visibility of risks to the EU financial sector. Improved information sharing, including a centralised mechanism for data access and sharing, could remedy some of these constraints.

For media queries, please contact Verena Reith, tel.: +49 69 1344 5737.

European Central Bank
Directorate General Communications
Sonnemannstrasse 20, 60314 Frankfurt am Main, Germany
Tel.: +49 69 1344 7455, email: media@ecb.europa.eu, website: www.bankingsupervision.europa.eu