

PRESS RELEASE

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Risks from outside euro area rise according to latest ECB Financial Stability Review

- Euro area financial system resilient to occasional bouts of financial market volatility
- Possibility of an abrupt increase of risk premia at global level has become more pronounced
- Balance sheet repair continues in banking sector amid rapid expansion in non-bank sector
- Sovereign and private sector debt remains high in several euro area countries

The euro area financial system has been resilient through occasional bouts of financial market volatility in the second half of the year, according to the ECB's latest Financial Stability Review. The twice-yearly report highlights that the likelihood of an abrupt rise in global risk premia has become more pronounced as concern shifts to emerging market economies.

The review finds that measures of systemic stress remained contained amid periods of stress related to turbulence during the summer in Greece, followed by a sizeable correction in Chinese asset prices.

While euro area banks have limited direct exposure to emerging market economies outside Europe, exposures have been gradually increasing in the euro area investment fund industry. As large emerging market economies have grown in their share of global economic output and financial market activity, so too has their role as drivers of global confidence.

The report also highlights improvement in the shock-absorbing capacity of the euro area banking system in the first half of the year. Both profitability and solvency positions of banks have improved. Challenges that euro area banks still face include a weak macroeconomic recovery, low profitability and a large stock of non-performing loans. Sovereign and private sector debt also remains high in several euro area countries. These factors continue to constrain banks' lending capacity and ability to build up further capital buffers. Looking ahead, banks – as well as insurers – may need to further adjust their business

models to cope with persistently weak economic conditions, along with an environment of historically low interest rates across the maturity spectrum.

The review also notes that financial stability risks stretch beyond traditional entities such as banks and insurers. The shadow banking sector continues to expand robustly at the global and euro area level. Vulnerabilities are likely to be accumulating below the surface as investment funds take more risk on their balance sheets.

The ECB has singled out four risks to financial system stability over the next two years:

- Increased risk of an abrupt reversal of global risk premia amplified by low secondary market liquidity
- Weak profitability prospects for banks and insurers in a low nominal growth environment, amid incomplete balance sheet adjustments
- Potential risk of rising debt sustainability concerns in the public and non-financial private sectors amid low nominal growth
- Increased potential risk of stress in a rapidly growing shadow banking sector amplified by spillovers and liquidity risk

The full report is available on the ECB's website www.ecb.europa.eu

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